Schulte Roth&Zabel

EUROPEAN BANK DEBT AND CLAIMS TRADING SEMINARS

Thursday, May 22, 2014

Overview of European Claims Trading

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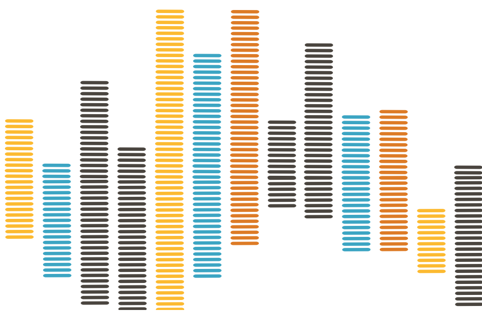
    - The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans
    - European Insolvency Claims Trading: Is Iceland the Paradigm?



Overview of European Claims Trading

1. Agenda

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Overview of European Claims Trading

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Agenda

I. Introduction to Claims Trading

II. Roadmap to Recovery

A. What is a claim?

B. Classification of claims

1. Proprietary claims
2. Secured creditors
3. Insolvency officers remuneration
4. Preferential creditors
5. Floating charge creditors
6. General unsecured
7. Shareholders

C. Recovery risk analysis

1. Amount/timing of distributions
2. Mitigation of risk

D. EU/U.K. recovery regimes

1. Administration
2. U.K. schemes of arrangement
3. Classification/treatment of claims
4. Procedure — distributions to creditors

E. Notional amount risk explained

F. Impairment

1. Clawbacks

2. Technical defects

III. Steps to a Trade

A. Trade structures and counterparty risk

B. Pre-trade issues

C. The assignment agreement

1. Recourse

2. Non-recourse: the deadly reps

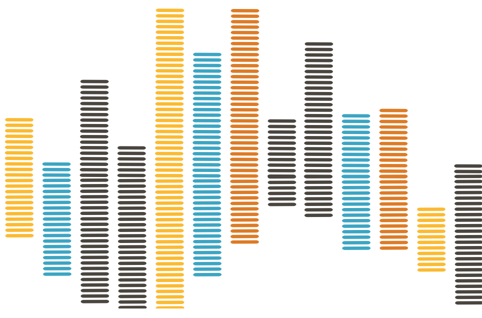
3. Holdback

(a) Counterparty risk

(b) Claim's notional amount subject to significant uncertainty

4. As-is — why would a buyer take the risk?

D. Settlement



Overview of European Claims Trading

2. Speaker Biographies and Key Contacts

David J. Karp
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David focuses his practice on corporate restructuring, special situations and distressed investments, distressed mergers and acquisitions, and the bankruptcy aspects of structured finance. He leads SRZ's Distressed Debt & Claims Trading Group, which advises on European, U.S. and emerging market debt and claims trading matters.

Among his broad work in reorganization and distressed investments, David has represented debtors, ad hoc and official committees, and individual secured and unsecured creditors. His recent representations include an investment fund in connection with the purchase of a multi-national distressed debt portfolio, an investment fund in connection with the auction of non-performing loan portfolio and an investment bank in connection with the sale of a distressed CDO portfolio. David frequently represents broker-dealers, investment funds, private equity funds and CLOs in connection with the auction and trading of distressed and non-performing assets across a wide range of issuers and in jurisdictions spanning the globe, including Arcapita, Petroplus, Swiss Air, Landsbanki, Glitnir, Kaupthing, Lehman Brothers Holdings Inc. and its affiliated debtors, MF Global Inc. and its affiliated debtors, American Airlines, Stallion Oilfield Services Ltd., Tribune Co. and Young Broadcasting Inc.

David is a frequent author and speaker on distressed investing topics and a regular contributor to the Distressed Debt Investing Blog, for which he recently wrote "Advanced Distressed Debt Lesson: What Bank Debt Trading on the Modern Day Back of the Napkin" and "Advanced Distressed Debt Trading & Trade Dispute Litigation: Debtor vs. Secondary Market Claims Purchaser." He also recently co-authored "LSTA's Revised Trading Documents Allow Revolver Loan Investors to Protect Their Posted Collateral – But Only If They Ask," for Pratt's Journal of Bankruptcy Law. David is an active member of the Loan Market Association, Asia Pacific Loan Market Association, INSOL Europe, Emerging Market Trade Association and the Loan Syndication Trading Association, where he is a member of the Trade Practices and Forms Committee.

David earned his J.D. from Fordham University School of Law and his B.S. from Cornell University.

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Sonya focuses her practice on European restructuring, distressed investing and financing. She represents hedge funds, private equity funds and other investors that are active in these markets. She has significant experience in analyzing distressed investments and restructuring strategies, and in representing clients in structured finance transactions, direct lending, NPL transactions and on the settlement of LMA and hybrid debt and claims trades. Sonya also advises private creditors and shareholders in connection with sovereign debt restructuring and financial institution restructurings where government intervention could result in subordination and disparate treatment of private investors. She also advises clients in connection with custody and prime brokerage matters.

Sonya frequently writes and speaks in her area of expertise. She is the author of "Restructuring of Structured Transactions: An Illustration of a Recent 'Win-Win' Situation," an article that appeared in *Insolvency Today*, and was a contributor to *Distressed Investing M&A*, a 2013 report created in association with Mergermarket and Debtwire. She also recently spoke on "Fund Strategies and Structuring" and "Distressed Opportunities in Europe" for SRZ-sponsored events.

Sonya holds an LL.M. from King's College, University of London, where she was a Commonwealth Scholar, and an LL.B. (first class honors) from the Queensland University of Technology. She also holds a Dip.Mus. from Conservatorium of Music (Old) and an A.Mus.A. (piano).

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Neil practices in the areas of business reorganization and distressed debt and claims trading. He serves both buy-side and sell-side as counsel in distressed investing transactions, and he has represented private equity firms, investment funds and financial institutions as investors and exiting creditors in distressed acquisitions and corporate restructurings, including advising on loan-to-own strategies, distressed asset sales and DIP financing. He also represents investment funds as buyers and sellers of distressed loans, bankruptcy claims, post-restructuring equity and other distressed investment products.

Neil has co-authored articles including "Beware the 'Meridian Sunrise' — District Court Rules Investment Funds Are Not 'Financial Institutions' Under Loan Transfer Restrictions," an SRZ Client Alert; "Fifth Circuit Upholds 'Absurd' Cramdown Interest Rate," in *Pratt's Journal of Bankruptcy Law*; and "District Court Upholds Future Claimants' Due Process Rights Against Broad Releases in Section 363 Sale Order," also in *Pratt's Journal of Bankruptcy Law*.

Neil earned his J.D., *magna cum laude*, from American University, Washington College of Law, and his B.A. from the University of Pennsylvania.

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Alexia's practice focuses on representing domestic and international hedge fund and investment bank clients in connection with the purchase and sale of European, U.S. and emerging market distressed assets, including bank debt and claims. She specializes in the preparation and negotiation of primary and secondary trading documentation under the Loan Market Association and the Loan Syndications and Trading Association regimes. She also advises clients in connection with the primary issuance of syndicated loans and swap obligations.

In addition to the above, Alexia has represented a major investment bank in the sale of a large portfolio of its assets to certain funds, has advised hedge funds on the development of their bank debt and claims trading procedures and has been engaged by clients to review and analyze credit agreements in connection with their interest to build positions in the debt of U.S. and European companies.

Alexia holds an LL.M. in Securities and Financial Regulation from Georgetown University Law Center and an International J.D. from the National and Kapodistrian University of Athens School of Law.

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Additional Key SRZ Contacts

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- Adam C. Harris is a partner in the New York office, chair of the Business Reorganization Group and a member of the firm's Executive Committee. 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
- Adam has represented a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court supervised and out-of-court restructurings

Craig Stein, Partner
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- Craig Stein is a partner in the New York office and co-head of the Structured Products & Derivatives Group. His practice focuses on swaps and other derivative products, including master repurchase agreements, total return swaps, credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions
- Craig represents private investment funds, collateral managers, issuers, underwriters and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs)

Peter J.M. Declercq, Partner
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- Peter J.M. Declercq is a partner in the London office where his international practice focuses on cross-border insolvencies, restructurings and distressed mergers and acquisitions
- Peter provides advice to distressed investors, including hedge funds, private equity funds and investment banks and he has a wealth of experience in leading formal and ad hoc creditor groups in connection with multinational in-court and out of court restructuring transactions. Peter also advises both financial and strategic buyers and sellers in the acquisition or divestiture of distressed assets across Europe

Anthony Lombardi, Associate
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- Anthony Lombardi is an associate in the London office, where he represents domestic and international hedge fund and investment bank clients in connection with the purchase and sale of European, U.S. and emerging markets distressed assets, including bank debt and claims
- Anthony specializes in the preparation and negotiation of secondary trading documentation under the Loan Market Association and has acted on a number of cross-border insolvencies and portfolio sales

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- Jay Williams is an associate in the New York office whose practice focuses on structured finance transactions, derivatives and fund formations
- Jay represents issuers, underwriters and investment managers in the structuring and negotiation of a wide variety of asset financings, including financings structured as credit derivatives, total return swaps, repurchase agreements and resecuritizations

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- Stephanie Blattmachr is an associate in the New York office, where she practices in the areas of bankruptcy, corporate restructuring, distressed investment and creditors' rights
- Stephanie represents creditors and lenders in complex Chapter 11 cases and out-of-court restructurings, hedge funds in bank debt trading and bankruptcy claims trading matters and various parties in securitization and CMBS transactions

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- Tal Reback is a debt trading coordinator in the New York office where she oversees quality control for the Distressed Debt & Claims Trading Group. Tal also assists attorneys in connection with capital structure analysis and settling U.S. and European bank debt and claims trades

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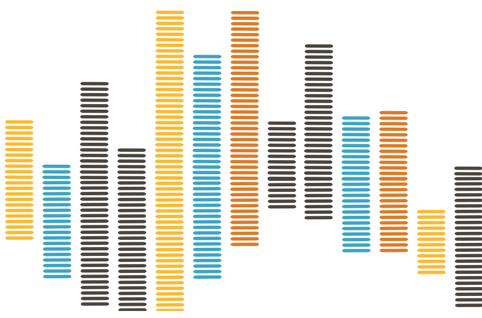

Overview of European Claims Trading

3. SRZ Capabilities

Distressed Debt & Claims Trading

SRZ's Distressed Debt & Claims Trading Group has extensive experience advising broker-dealers, hedge funds, investment banks, CLOs and private equity funds on a wide range of U.S., European, Asia-Pacific and emerging markets debt and claims trading matters. When not managed properly, trade and transfer risk issues can push a potentially winning investment into losing territory. Our attorneys understand our clients' goals and have the transaction skills and commercial sense required to facilitate execution and settlement of trades. The group advises clients in structuring, preparing and negotiating deal-specific transaction documentation including: trade confirmations, debt and post-reorganization equity purchase and sale agreements, claim assignment agreements, participation agreements, proceeds letters, confidentiality agreements, "big boy" letters, and bid procedure documentation.

The Distressed Debt & Claims Trading Group's attorneys often play a central role in transactions having a trading component, while working closely with lawyers from the firm's other practice groups, including the distressed investment, business transactions, finance, investment management, business reorganization, structured products & derivatives, litigation, regulatory & compliance and tax.

Bank Debt Auctions

We advise clients participating as buyers or sellers in auctions for bank debt portfolios. We prepare bid documentation, collect bids, assist our clients in evaluating bids, and guide our clients through the bidding and settlement process, including negotiating and finalizing transaction documentation. When acting for buyers, we analyze and advise on issues relating to the underlying claim documentation and negotiate claims transfer documentation.

Bulk Transfers and Portfolio Analysis

Our attorneys advise our clients as both buyers and sellers in bulk transfers of claim and debt portfolios and provide a full analysis of the underlying claims recovery, credit review and transfer issues.

Rights Offerings

The group advises clients as participants or backstop parties of debt and equity rights offerings in connection with a debtor's plan of reorganization. When our clients are the beneficial, but not the record holder, of the debt or equity entitled to participate, our lawyers ensure that our client's right to participate is thoroughly documented and protected. We understand how crucial it can be for our clients to receive the proceeds of a purchase of access to a rights offering as soon as possible. Accordingly, subsequent to the successful rights offering, we ensure that the transfers of any proceeds are settled in a timely and complete manner.

Bank Debt Trading

We regularly advise buy-side and sell-side clients at each stage of a debt or claims transaction. In addition to highlighting the trade risks associated with any given trade and formulating the optimal settlement or structuring options, we represent clients in the negotiation of trade confirmations, purchase and sale agreements, participation agreements, proceeds letters, and "big boy" letters. With attorneys based in New York and London, we provide prompt and efficient responses to issues arising in any time-zone, while working cohesively to achieve a timely settlement of trades.

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Our attorneys are active members of the Loan Syndications and Trading Association (LSTA), Loan Market Association (LMA) and Asia Pacific Loan Market Association (APLMA) and have long-standing familiarity with the protocols and recommended documentation advocated by each association. Our attorneys have a comprehensive understanding of the U.S., European, Asian-Pacific, and emerging secondary loan markets and how to facilitate transfers of loans worldwide. With extensive expertise in analyzing all forms of credit documents, we are able to quickly and thoroughly locate and identify commercial and legal complexities that exist on a trade-by-trade basis.

Bankruptcy Claims Trading

The group advises buyers and sellers on all aspects of bankruptcy claim trading transactions ranging from bilateral transfers to complex multi-party claims auctions. The group's attorneys structure, prepare and negotiate the transaction documents, review and analyze the underlying proofs of claim and supporting documentation and file any transfer notices. Our lawyers expertly address the various risk silos that can impact claims trades, including notional, recovery and counterparty risk, to meet our clients' requirements. The group guides each client's understanding of the critical terms of the trade to be negotiated at each step of the deal process in order to maximize leverage.

Club Syndications of Claims

We regularly advise clients in structuring and participating in club syndication deals and joint-venture claim participations. We negotiate and structure each transaction step to appropriately address recovery, notional amount, and counterparty credit risk, voting, control and information rights.

Leverage Opportunities

We design structures that enable our clients to leverage their bankruptcy claims positions. In conjunction with SRZ's Finance and Structured Products & Derivatives Groups, we advise clients on leverage opportunities where the clients' claims serve as collateral for a loan or structured product. Using a cross-departmental approach, our lawyers analyze the underlying claims and any transfer documents to protect our client's interests and simultaneously achieve the best possible financing terms.

Claims Trade Auctions

We advise sellers and buyers in auctions of bankruptcy claims. For sellers, the group's attorneys prepare bid documentation, collect bids, assist our clients in evaluating bids, and guide our clients through every stage of the bidding and settlement process. When acting for buyers, we analyze and advise on issues relating to the underlying claim documentation and negotiate claims transfer documentation.

Compliance

SRZ regularly provides regulatory and compliance advice on the interaction between LSTA and LMA guidelines and U.S. and European securities laws. The Distressed Debt & Claims Trading Group remains up-to-date with regulatory legislation that is in effect or in development, and continually monitors the interplay between securities laws in the United States and Europe and the position of bank debt and claims as an asset class. Our attorneys routinely advise clients on trading in different levels of a company's capital structure, the relationship between a company's equity and bank debt, and the position of clients trading on the basis of syndicate confidential information and borrower confidential information.

Post-Reorganization Equity Trading

In conjunction with the Business Transactions and Regulatory & Compliance Groups, SRZ's Distressed Debt & Claims Trading Group guides clients through the oft-novel intricacies of trading and settling post-reorganization equity trades. Many compliance and logistical considerations can affect the liquidity and settlement of securities when a company issues new equity under a Chapter 11 plan, an English law scheme of arrangement, or another form of restructuring. The new equity holders (who are often debt traders), the reorganized company, and transfer agents, will often be unaccustomed to settling post-reorganization equity trades, and unfamiliar with the governing terms of the new equity instruments or the provisions in the

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underlying stockholders' agreement. The group's attorneys understand the unique issues facing the various parties in settlement of post-reorganization equity transactions and will work with them and their respective advisers to establish consensus on all necessary transfer documents and steps, including, if required, any securities law opinions.

North American Credits

American Axle & Manufacturing Inc., Aveos Holding Co., Capmark Financial Group Inc., Carey International Inc., Charter Communications, Cinram International Inc., Citadel Broadcasting Corp., Clear Channel Communications Inc., Consolidated Container Co., Dana Holding Corp., Delphi Corp., Delta Air Lines Inc., Dex Media West, FairPoint Communications Inc., Ford Motor Co., Freedom Communications Inc., Freescale Semiconductor Inc., Generac Holdings Inc., General Growth Properties Inc., General Motors Corp., Georgia Gulf Corp., Hawker Beechcraft Corp., Hexion Specialty Chemicals Inc., Idearc Inc., Las Vegas Sands Corp., Lear Corp., Lee Enterprises, Lehman Brothers Holdings Inc. (and its affiliated U.S., U.K. and Bermuda debtors), Metroglass Finance Ltd., Pacific Ethanol Inc., Penton Media Inc., Pope & Talbot Ltd., Quality Home Brands Holdings, SemGroup Corp., Simmons Bedding Co., Spectrum Brands Inc., Stallion Oilfield Services Ltd., Tribune Co., Tropicana Entertainment, United Air Lines Inc., Univision Communications Inc., US Airways Group Inc., Visteon Corp., Xerium Technologies Inc. and Young Broadcasting Inc.

European Credits

AbitibiBowater Inc., Aleris International Inc., Arcapita Bank B.S.C., Barchester Holdco Ltd., Centro Properties Group, Consolis Group, Cucina Acquisition (U.K.) Ltd., Eircom Group Ltd., Essent Trading International SA, Gala Group PE, GHG Group PLC, Glitnir Bank hf., Hilding Anders, Incisive Media, Infigen Energy Finance, The Investment Dar Company K.S.C.C., Ivg Immobilien AG, Ivg Immobilien-Management Holding AG, Kaupthing Bank hf., Klakki EHF (EXISTA), Landsbanki Íslands hf., Materis SAS, MF Global UK, Quinn Group Ltd., SAAD Investments Company Ltd., Seat Pagine Gialle, Stemcor Holdings Ltd., Swiss Air SA/AG, Syncora Holdings, WHA Holdings and Wheelabrator Allevard.

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Business Reorganization Group

The Business Reorganization Group at Schulte Roth & Zabel represents domestic, foreign and international secured creditors, unsecured creditors, debtor-in-possession lenders, acquirers, equity holders, plan sponsors and others in Chapter 11 reorganizations and out-of-court workouts, and regularly advises on acquisitions and divestitures of troubled companies and their assets.

With market-leading capabilities on both sides of the Atlantic, SRZ's Business Reorganization Group prides itself on accessibility to clients and responsiveness to their needs. The group is well-positioned to represent domestic and international clients in all aspects of business reorganization — in-court and extrajudicial, transactional and adversarial — and our global clients benefit from the broadened perspective this brings to the handling of their matters. Because our lawyers are able to tap into such an extensive vein of experience, they are able to provide more than just technical expertise, but also develop effective, creative and efficient strategies to best achieve clients' business objectives.

Creditor Representations

- Secured and unsecured
- Creditors' committees
- Indenture trustees
- Bondholders in workouts and reorganization cases
- Secured lenders in debtor-in-possession and reorganization-plan financing
- Commercial lessors (real estate, equipment)

Acquisitions and Divestitures of Troubled Entities

- Formulate reorganization plans
- Represent reorganization-plan equity sponsors
- Structure and negotiate merger, acquisition and divestiture transactions
- Represent financial and strategic buyers and sellers in domestic and cross-border transactions across a wide variety of business sectors, including airlines, banking, chemicals, financial services, health care, investment management, real estate, manufacturing, hospitality and telecommunications

Reorganizations and Debt Restructurings

- Out-of-court debt and equity restructurings
- Bankruptcy reorganizations and liquidations
- Formulate reorganization plans and representation of reorganization plan equity sponsors
- Foreclosures, deeds in lieu of foreclosure, and recovery of rents and other income
- Real estate restructurings, including non-judicial workouts and Chapter 11 reorganizations

Bankruptcy Litigation

- Defend claim challenges (preference, fraudulent transfer, equitable and contractual subordination, recharacterization deepening insolvency claims and lender liability suits)
- Litigate leasing, financing and cash collateral, valuation and insolvency, assumption and rejection, true-sale, lien priority and jurisdictional disputes

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- Counsel directors of troubled companies regarding their fiduciary duties
- Handle retention and compensation matters for professional firms (financial advisory, accounting and law)
- Prosecute and defend breach of fiduciary duty claims
- Litigate contested plan confirmations and disputes involving stay relief, adequate protection, substantive consolidation, turnover and reclamation
- Defend insider and tax litigation
- Arbitration, mediation
- Testify and consult as expert witness

Transaction Counseling

- Analyze and formulate corporate, real estate, finance and other transaction structures to minimize potential bankruptcy and related risks
- Individual asset protection (e.g., exemption counseling)

Real Estate Restructuring

- Non-judicial workouts
- Real estate reorganizations

Financially Troubled Companies

- Represent financially troubled entities in out-of-court restructurings and Chapter 11 reorganizations
- Formulate prepackaged and prearranged reorganizations

Distressed Debt and Claims Trading

- Represent buyers and sellers of distressed debt
- Negotiate and close LSTA and LMA distressed debt purchase and sale transactions
- Provide legal analysis and due diligence on distressed companies and related indentures and credit facilities

Prime Broker and Counterparty Issues

- Advise prime brokerage customers with respect to risks, rights and remedies associated with financially troubled broker-dealers
- Advise participants to financial markets contacts with respect to counterparty insolvency risks

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Distressed Investing

SRZ's Distressed Investing Group is unique in its ability to meet the complex needs of investment funds and other creditors in every phase of distressed investing. As the premier brand in investment management in the two key financial markets — New York and London — we are recognized as leaders in both the mature U.S. distressed investment market and the still developing European distressed investment market.

With market-leading capabilities on both sides of the Atlantic, SRZ is well-positioned to advise clients on all aspects and contexts of distressed investing and have extensive experience with out-of-court transactions, distressed real estate, capital structure analysis, trading issues and navigating bankruptcies, including bankruptcy acquisitions, debt restructurings, loan-to-own strategies and debtor-in-possession and exit financings. Structuring or restructuring a deal may also require collaboration by our clients with one or more other parties who have aligned interests in order to achieve their investment objectives. In these cases, we regularly advise consortiums and syndicates in joint investments, whether those investments are structured as club deals, or the group acts together as an informal, ad hoc committee, or otherwise. Our attorneys are experienced in defining, negotiating and navigating those working relationships and managing the complex governance and tax issues that arise.

What makes SRZ unique is that our Distressed Investing Group is a strategic blend of attorneys from our business reorganization, finance, investment management, mergers and acquisitions, real estate, tax and our other practice areas. This interdisciplinary approach allows us to meet the complex needs of our clients, give comprehensive representation and advise investors in all manner of distressed situations. Our superior knowledge of the investment management industry and experience developing and implementing the structures and products that a distressed investor analyzes results in substantial synergies and gives us an insider's edge.

Out-of-Court Restructuring

SRZ advises clients in complex domestic and international out-of-court restructurings of financially troubled companies, including debt or operational restructuring, refinancing, workout, recapitalization, acquisition or divestiture. While bankruptcy may be the best means for restructuring a company that has significant labor, pension or environmental concerns, or that requires significant contractual concessions or terminations, in many cases, an out-of-court solution is a more effective, less expensive, lower risk and less public alternative. We assist in determining whether an out-of-court restructuring is viable by thoroughly analyzing the capital structure and existing creditor, intercreditor and inter-lender relationships and provide comprehensive advice on every aspect of the restructuring process, including structuring the transaction, managing corporate governance and securities law issues, negotiating amendments, consent solicitations and exchange offers (including strategies to address potential hold-outs) and the related tax implications of the restructuring. These representations frequently involve amending loan agreements or bond indentures, exchanging debt for equity, selling assets and negotiating with stakeholders across various levels of the capital structure.

Acquisitions Under 363 and Plans of Reorganization

We advise on distressed M&A activities, including § 363 sales (whether as a "stalking horse bidder" or as an auction participant) and acquisitions by way of sponsored or stand-alone reorganization plans. We also guide investors in crafting and implementing alternative investment and financing tactics, including "loan-to-own" strategies like using senior debt claims to credit bid on distressed assets or existing debt securities to confirm a plan of reorganization and emerge with equity. We provide practical solutions to the complicated corporate governance issues that increasingly are arising from diverse post-transaction shareholder bases, and also provide creative tax structures to minimize a target's cancellation of indebtedness income and to preserve net operating losses. Our interdisciplinary approach enables us to offer a team of experienced professionals with across-the-board expertise in dealing with the unique structuring, strategic, diligence, finance and documentation issues that arise in distressed M&A transactions.

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Debtor-in-Possession and Exit Financing

SRZ is a nationally recognized leader in complex, multi-faceted financings, including lending to bankrupt borrowers. We are experienced in structuring, negotiating and managing financing transactions in bankruptcy cases, including debtor-in-possession financings and exit facilities implemented through Chapter 11 plans of reorganization, providing advice on transactions across the debtor's capital structure, including senior and junior secured debt, term and revolving loans, bridge facilities, and subordinated or mezzanine debt. We advise on all types of debt financing to distressed debtors, whether they are roll-ups of existing debt or new loans. We assist numerous clients in successfully consummating these transactions on accelerated timetables. We also have a successful track record representing clients in troubled real estate financing deals and bankruptcy situations. We've represented secured and unsecured creditors, loan servicers, special servicers, acquirers and other interested parties in workouts, debt and equity restructurings and recapitalizations, mortgage foreclosures, deeds in lieu of foreclosure, defaulted-loan litigation, receiverships, Chapter 11 cases, cramdowns, and distressed debt and property dispositions.

Global

Our clients include domestic and international buyers and sellers in joint venture, LLC and partnership transactions. Our transatlantic presence and deep multinational experience is particularly sought by domestic and international investors who are increasingly looking at U.K. and European opportunities involving cross-border insolvencies, restructurings and distressed mergers and acquisitions. We also have significant experience representing global investors, including private equity real estate funds and REITs, and developers, in the acquisition and development of distressed real estate, whether single-asset or multi-property, developed or undeveloped, and commercial or residential, and with the related capital markets transactions, from subordinated financings and intercreditor arrangements to equity financings. Our attorneys' global range of expertise includes multilingual and multicultural proficiencies that allow us to deliver seamless high-quality service to our clients. Our interdisciplinary teams set us apart from other firms our size, allowing us to work seamlessly on matters and address cross-border tax, collateral and insolvency issues in relation to a distressed investment.

Practice Highlights

- Awarded "Special Situation M&A Deal of the Year" (above $750 million) by Global M&A Network for work on The Innkeepers USA Trust Chapter 11 reorganization and sale to Cerberus Capital Management LP and Chatham Lodging Trust
- Awarded the Global M&A Deal of the Year for our role in the sale and reorganization of Chrysler LLC
- Structured a series of refinancing transactions for which NewPage received the "High-Yield Bond Deal of the Year" by *International Financing Review*
- Acquisition of Caritas Christi Health Care was awarded the North America Private Equity Deal of the Year by Global M&A Network and named *Investment Dealers' Digest* magazine's 2010 Deal of the Year award in the health care category
- Partners in the Distressed Investing Group are consistently recognized by leading legal directories including *Chambers USA*, *The Legal 500 United States* and *International Financial Law Review*

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Leveraged Credit Investment Products

With an approach to trading and investments in leveraged debt products built on deep experience and active innovation, Schulte Roth & Zabel advises leading market participants with investments in and trading of all types of financial products — from secured and unsecured loans and loan participations (both par and distressed), mortgage loans, illiquid debt and equity, to more complex structured credit products. By combining the expertise from our structured products, derivatives, trading agreement and distressed debt trading practices, SRZ is able to offer a seamlessly integrated, multidisciplinary, U.S. and European capability that is widely recognized both for its market leadership and for the results that it delivers to our clients.

SRZ's team counsels a diverse client base, including investment managers, hedge funds, private equity funds, ERISA plans, registered investment companies, UCITS, SICAV funds, broker-dealers and financial institutions. Our approach to representing our clients blends technical expertise, an understanding of current market conditions and sophisticated legal and commercial analysis of each transaction with a deep knowledge of our clients and their objectives. As credit markets begin to recover from the global financial crisis, we believe that our approach is the most effective way to create solutions tailored to a client's individual needs.

We assist our clients with the acquisition and financing of investments from the initial due diligence and analysis of underlying documentation to the negotiation and preparation of financing facilities for both borrowers and lenders, including:

- Warehouse lending agreements
- Total return swaps and other derivatives
- Repurchase agreements
- Credit agreements
- Capital call lines and subscription facilities

Our lawyers are well-versed in the many types of transactional documents that clients may encounter in this market, from market-standard trade documentation, where our expertise includes broad familiarity with forms published by industry trade groups such as the International Swaps and Derivatives Association (ISDA), the Loan Syndications and Trading Association (LSTA), the Loan Marketing Association (LMA), the Emerging Market Trade Association (EMTA), the Securities Industry and Financial Markets Association (SIFMA) and the International Securities Lending Association (ISLA), to heavily customized and negotiated agreements specific to a particular transaction or counterparty.

SRZ's team also works closely with other areas of the firm — including tax, regulatory, investment management, bankruptcy and restructuring — to bring specialized U.S. or U.K. law expertise to legal issues affecting our clients in the current market environment, including issues arising under the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (and SEC/CFTC regulations thereunder) and the U.K. Financial Services Act (and FSA regulations thereunder).

The recovery in global credit markets has resulted in an increasing number of opportunities to invest in both pre-crisis and new-issuance debt products, but the fundamental risks to investors has not changed. SRZ can help you navigate the potential pitfalls in the secondary loan market by providing a comprehensive, fully-integrated approach to each client and each transaction in an efficient and cost-effective manner.

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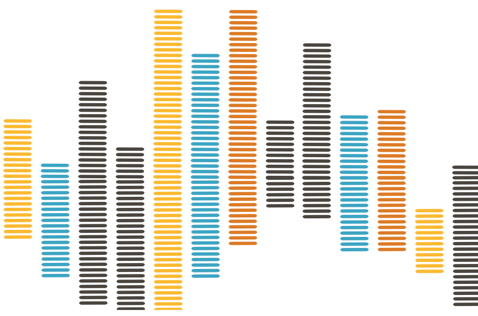

Overview of European Claims Trading

4. PowerPoint Presentation

Roadmap to Recovery

- **What is a claim?**
- **Classification of claims**
  - Proprietary claims
  - Secured creditors
  - Insolvency officers remuneration
  - Preferential creditors
  - Floating charge creditors
  - General unsecured
  - Shareholders

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Roadmap to Recovery

- **Recovery risk analysis**
  - Amount/timing of distributions
  - Mitigation of risk

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Roadmap to Recovery

- **EU/U.K. recovery regimes**
  - Administration
  - U.K. schemes of arrangement
  - Classification/treatment of claims
  - Procedure — distributions to creditors

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Roadmap to Recovery

- **Notional amount risk explained**
- **Impairment**
  - Clawbacks
  - Technical defects

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Steps to a Trade

Trade Structures and Counterparty Risk

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Steps to a Trade
Pre-Trade Issues

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Steps to a Trade

- **The assignment agreement**
  - Recourse
  - Non-recourse
  - Holdback
  - As-is

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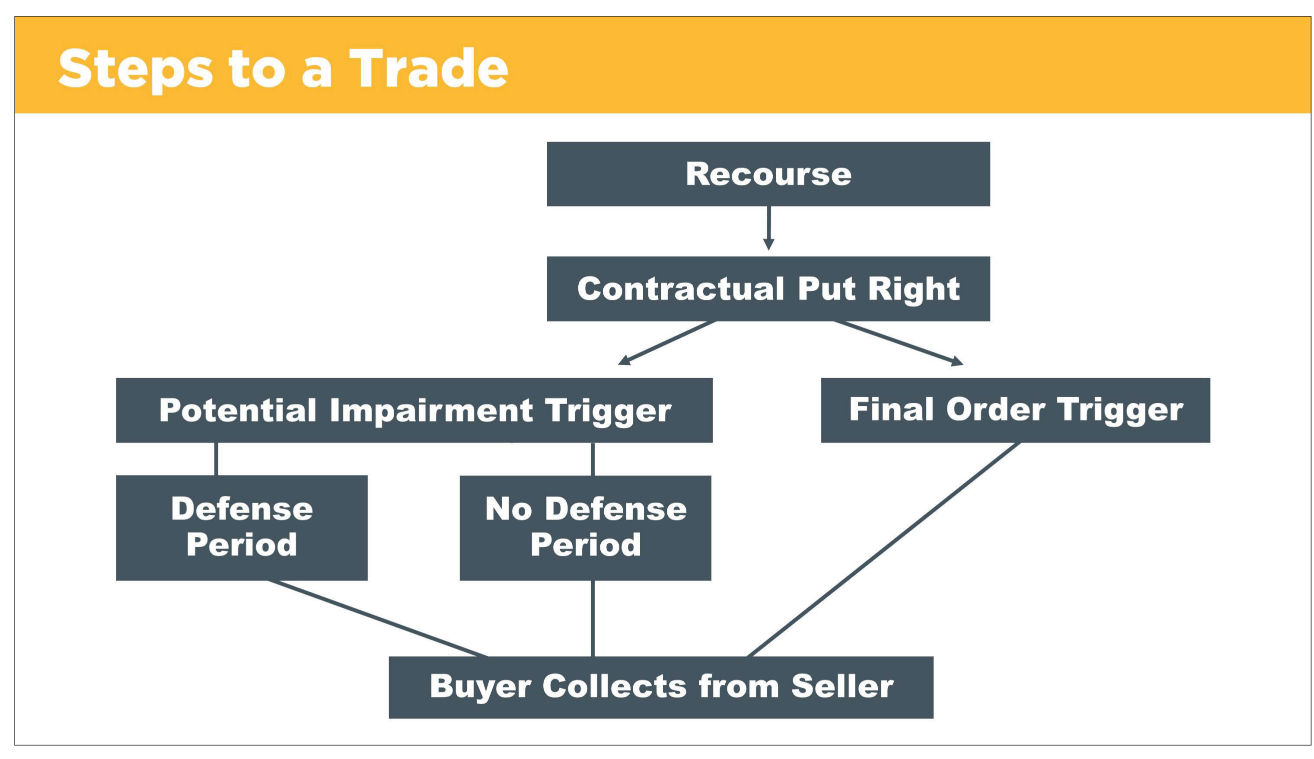

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Steps to a Trade: Non-Recourse

The Deadly Reps

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Steps to a Trade: Holdback

- Significant counterparty risk
- Claim's notional amount subject to significant uncertainty

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Steps to a Trade: As-Is

Why Would a Buyer Take the Risk?

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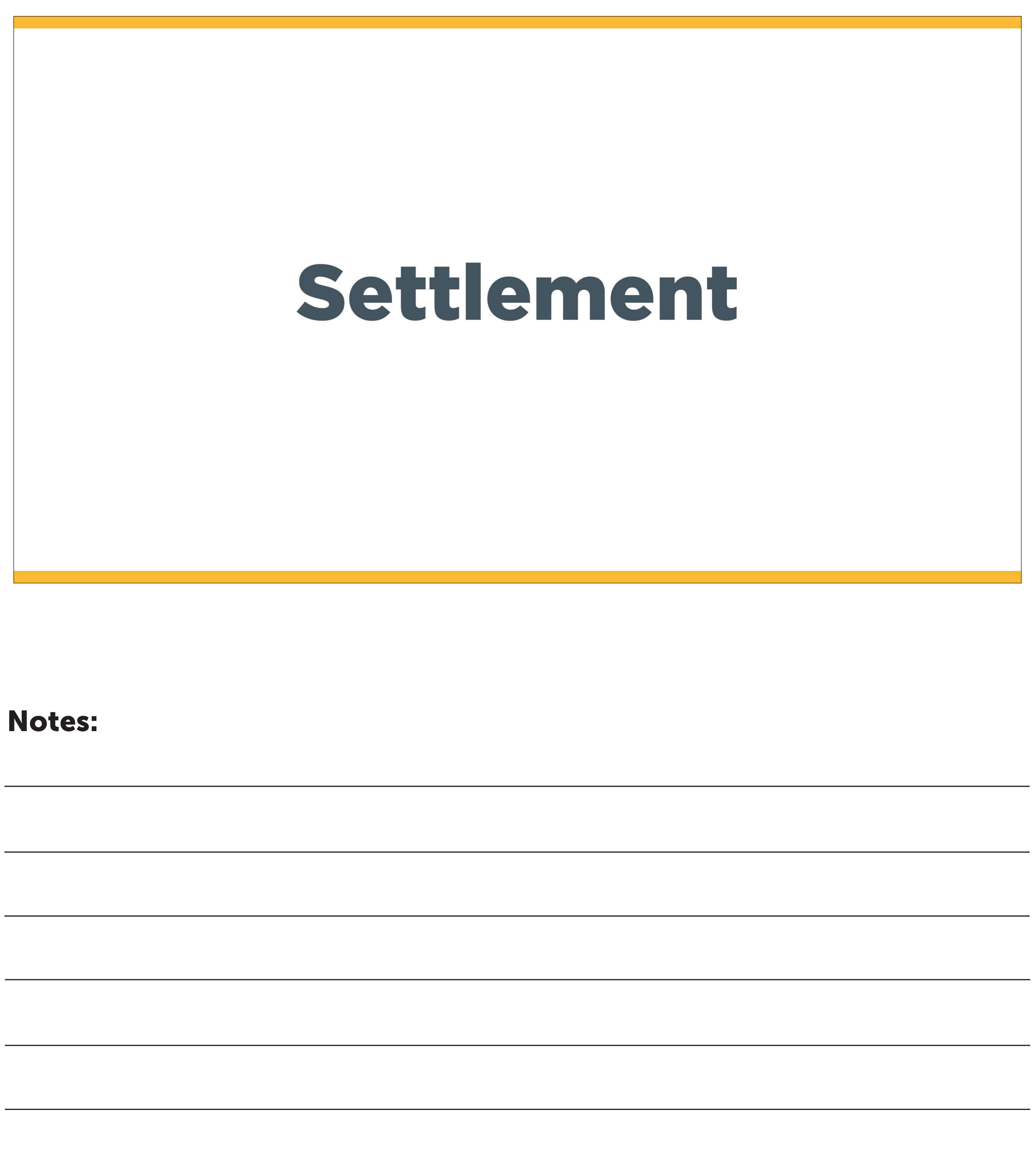

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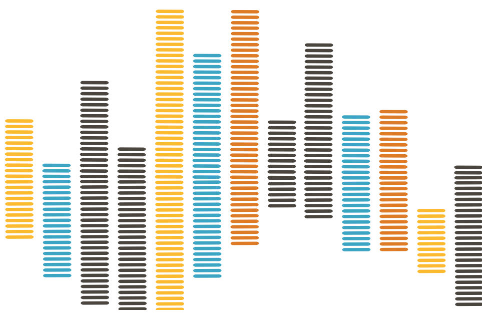

Overview of European Claims Trading

5. Distressed Debt Trading Strategies: Impact of Recent Litigation

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Distressed Debt Trading Strategies: Impact of Recent Litigation

I. Bankruptcy Claims Trading

A. Buyers of bankruptcy claims must evaluate at least three types of risk when analyzing a potential investment:

1. Recovery risk (i.e., the percentage of each dollar of claim the claimholder expects to receive as a distribution and the timing of that distribution);

2. Notional amount risk (i.e., the risk that the face amount of the claim will be reduced, in whole or in part, or subordinated to other similarly situated claims); and

3. Counterparty credit risk (i.e., the risk that the seller is not able to make good on the monetary damages or indemnification owed the buyer (in trades in which the buyer has recourse against the seller)).

B. Pre-trade diligence

1. Recovery risk is principally addressed in the buyer's analysis of the debtor's likely restructuring or liquidation options. To a certain extent, notional amount risk and counterparty risk can be mitigated by the purchaser's due diligence on the specific purchased claim and the counterparty before agreeing to a trade. This will include identifying the selling counterparty and determining whether the buyer is comfortable transacting with the seller.

2. *In re KB Toys et al.*, No. 04-10120, Dkt. 6012, 2012 WL 1570755 (Bankr. D. Del. May 4, 2012). A financial buyer ("Buyer") purchased trade claims against KB Toys, Inc. ("KB Toys") without performing basic due diligence on the claims. KB Toys had filed a Statement of Financial Affairs ("SOFA") almost a month before the Buyer had purchased any claims. The SOFA listed nine of the original holders of claims purchased by the Buyer in its "Preference Section" and on a list of creditors who received potentially avoidable transfers.[1] The Buyer even acquired one claim *after* the residual trustee for KB Toys ("Trustee") obtained a default judgment against the original claim holder. Judge Carey of the District of Delaware bankruptcy court disallowed the claims in full after finding that the Buyer was on constructive, if not actual, notice that the claims it purchased may be subject to disabilities,[2] stating that even without notice, a purchaser of claims in a bankruptcy should be well aware "that it is entering an arena in which claims are allowed and disallowed in accordance with the provisions of the Bankruptcy Code and the decisional law interpreting those provisions . . . ." Judge Carey's decision was upheld by the Delaware District Court and the Third Circuit.[3] The takeaway lesson is that the Buyer may have avoided litigating its claims in the first place if it had either thoroughly diligenced the claims or negotiated better protections from its seller counterparty.

C. Investment criteria and assessment of individual claim should guide determination of purchase structure

1. Recourse trade — Buyer is granted an automatic right to put the claim back to the seller if the notional or face amount of the claim is impaired or, in certain instances, if the claim is simply objected to by a third party.

2. Non-recourse trade — Buyer does not have put right, but generally obtains representations, warranties and indemnities from the seller covering impairment risk. Together, these may allow the buyer to end up in the same economic position as it would be with a recourse trade by litigating against the seller. However, it is significant that the buyer generally must suffer actual damages as a result of such breach before it can assert its remedies.[4]

---

[1] Under 11 U.S.C. § 547(b), a trustee may recover certain funds related to a pre-bankruptcy transfer made by an insolvent debtor to, or for, the benefit of a creditor, when the transfer occurs no more than 90 days before the bankruptcy filing was made, or within one year of filing if the creditor is an insider.

[2] *In re KB Toys et al.*, No. 04-10120, 2012 WL 1570755, at 19 (Bankr. D. Del. May 4, 2012).

[3] *In re KB Toys Inc., et al.*, Civ. No 12-716 (D. Del. entered Jan. 4, 2013); *In re KB Toys Inc.,* Case No. 13-1197 (3d Cir. Nov. 15, 2013).

[4] The following is an example of an indemnification by the Seller:

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3. As-is trade — Buyer assumes the claim's notional amount risk. In practice, this may result in the seller delivering equivalent representations and warranties as in a non-recourse structure, but qualified based on the knowledge of the seller. In short, the risk of the unknown is shifted to the buyer. In this type of trade, the buyer may require a purchase price holdback until the notional amount is settled. As many buyers purchase claims with the intent of only taking recovery risk, this is the most difficult structure for sellers to achieve. However, an "as-is" structure may be appropriate when the claim has been allowed by a final non-appealable order.

D. Recourse claims purchase — Can you rely on representations and warranties?

1. Recent litigation has shown that recourse through representations and warranties may not always be straightforward. In a pair of cases separately decided in the Southern District of New York, Longacre Master Fund, Ltd. ("Longacre") was unable to convince two different trial courts that the representations and warranties of sales contracts should apply after the date the agreements were fully executed (the "Effective Date"). In both *Longacre Master Fund, Ltd. v. D&S Machine Products, Inc.*, No. 10-6090 (S.D.N.Y. Feb. 14, 2011), and *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, 456 B.R. 633 (S.D.N.Y. Aug. 4, 2011), Longacre sued the seller, asserting that an avoidance action filed against the seller and an objection filed by the debtor to the claim triggered its put right and caused the seller to breach the representations and warranties of the assignment agreement. Longacre appealed both decisions to the Second Circuit Court of Appeals. While the Second Circuit vacated and remanded the district court's decision in *ATS*,[5] the parties settled the dispute in *D&S* prior to any hearing on the merits. Nonetheless, as only some parts of each decision by the district court were appealed, certain aspects of these decisions remain valid legal precedent.

2. Although the two courts ruled differently as to Longacre's right to exercise its put, neither court was willing to find, at the summary judgment stage, that the contract unambiguously required representations and warranties to be satisfied after the Effective Date. In *ATS*, Judge Sweet explicitly stated that the contract called for the truthfulness of the representations and warranties to be evaluated on the Effective Date in *ATS* because they were not expressly forward-looking.[6] In *D&S*, Judge Pauley found that a representation that the claim "*will not* be disputed or defended [ ] is arguably contrary to the reasonable expectation of the parties because it would require D&S to make warranties and representations regarding matters over which it has no control."[7] This reluctance to interpret the representations and warranties as forward-looking is contrary to the investment expectations of many market participants. Moreover, this issue was not appealed in either the *ATS* or the *D&S* cases.

3. Notably, in *ATS*, Delphi had filed objections to preserve its rights against ATS under 11 U.S.C. § 502(d).[8] Judge Sweet dismissed Longacre's counts for breaches of representations and warranties on substantive grounds. Specifically, he held there was no breach of the representation because a Section 502(d) objection itself does not contest the validity or amount of, and is not a lien or encumbrance on, the claim.[9] On appeal, the Second Circuit reversed the district court on this issue,

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The Seller agrees to indemnify and hold the Buyer, its successors and assigns and its officers, directors, employees, agents and controlling persons harmless from and against any and all losses, claims, damages, costs, expenses and liabilities (collectively defined as "Buyer Damages") (including reasonable attorneys' fees, but excluding consequential Buyer Damages) that are actually incurred and caused by: (i) the Seller's breach of its express representations, warranties, agreements or covenants made in this Agreement; or (ii) any obligation to disgorge to or to reimburse or pay any person for any payments, property or collateral actually received or applied by Seller under or in connection with the Transferred Rights, except to the extent any such payment, property or collateral has been distributed by the Seller to the Buyer (including, without limitation, a credit to the Purchase Price).

[5] *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, No. 11-3414-cv, sum. order, (2d Cir. Sept. 14, 2012).

[6] *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, 456 B.R. 633, 642-643 (S.D.N.Y. Aug. 4, 2011) ("The representations and warranties were made as of Dec. 14, 2006 (the 'Effective Date'), the date the Agreement was fully executed, and do not purport to serve as a guarantee of the future.").

[7] *Longacre Master Fund, Ltd. v. D&S Machine Products, Inc.*, No. 10-6090, at 4 (S.D.N.Y. Feb. 14, 2011) (emphasis in original).

[8] Under Section 502(d) of the Bankruptcy Code, the court shall disallow any claim of any entity from which property is recoverable or that is a transferee of a transfer avoidable as a preference or a fraudulent transfer unless such entity or transferee has paid the amount or turned over the property to the estate.

[9] Note that Longacre did not appeal the dismissal of its second (i.e., the claim was "Impaired" due to off-set), third (i.e., breach of "valid claim" representation), fourth (i.e., breach of representation that seller has no liability or obligation as to the claim) and fifth (i.e., breach of representation that claim is free from liens, encumbrances and set-offs) causes of actions. Thus, these dismissals were not reviewed by the Second Circuit.

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holding that the agreement did not require an objection to be meritorious; all it required was an objection filed by Delphi. Further, the representation that the claim was not subject to any "defenses, claims, rights to set-off, avoidance, or disallowance" was knowledge-qualified and Longacre failed to prove that ATS had knowledge of the possibility of a Section 502(d) objection to the claim. The Second Circuit reversed the district court on this issue as well, because it found there were material issues of fact as to whether ATS knew of a possible impairment. It was undisputed that ATS had received a payment during the preference period, which raised the issue of a possible impairment of the claim. Accordingly, the Second Circuit remanded this issue for further proceedings.

4. The lesson of these cases is that if a buyer wants its seller to accept the risk that its representations and warranties become untrue in the future, then the purchase agreement should clearly state which representations are expected to be true in the future as well as on the date of the agreement. Even though Longacre may have understood its contract to require as much, two judges apparently felt otherwise.[10] A further lesson is that a knowledge qualified representation effectively requires the injured party to prove its counterparty knew of the breach. Such forward-looking language may be as follows:

   (a) The Claim is, *and at all times hereafter shall each be*, an allowed, valid, liquidated, undisputed and non-contingent claim enforceable against the Debtor, in an amount not less than the Claim Amount; or

   (b) The Claim is not subject to any valid defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action, in whole or in part, whether on contractual, legal or equitable grounds, that have been *or may be asserted* by or on behalf of the Debtor or any other party to reduce the amount of the Claim or affect its validity, priority or enforceability (including, but not limited to, such actions which have been taken or could be asserted against any desk, group or division of the Seller which conducted business with the Debtor in the name of the Seller).

E. Recourse claims — What triggers a put right?

1. Longacre's assignment contracts with ATS and D&S granted Longacre a put right if the claim was "objected to." The two courts, however, ruled differently as to whether the debtor, Delphi, had "objected to" the claims when it filed an objection in order to preserve its rights under 11 U.S.C. § 502(d). In *D&S*, the court broadly interpreted "objection" and found that the put right was triggered by Delphi's filing of its Section 502(d) objection. However, in *ATS*, Judge Sweet held that the "objected to" language of the put right only referred to objections that challenge the validity or enforceability of the claim in the hands of the transferee. Analyzing the merits of the objection, the court found that the debtor's "objection" was actually just a reservation of its right to object to the claim in the future. As mentioned above, the Second Circuit vacated this aspect of Judge Sweet's decision. The Second Circuit analyzed the assignment contracts and found no requirement for a substantive objection. Rather, the objection filed by Delphi was "all the assignment contract required" to trigger Longacre's put right.

F. Impairment — The claim or the claimant?

1. Sale versus assignment

   (a) Under Section 502(d) of the Bankruptcy Code the court must disallow any claim of any entity that is a transferee of a transfer avoidable under Section 547 (i.e., the preference section). Courts have differed on the issue of whether "any claim of any entity" means only the "claimant," meaning that the disability rests only with the original claimant, or the "claim," meaning that the disability travels with the claim into the hands of others.

   (b) In *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) ("*Enron I*"), a Southern District of New York bankruptcy judge held that disabilities travel with the claim. Therefore, a claim holder could not protect a claim from equitable subordination simply by selling it to another party.

[10] It is worth noting that the contracts at issue in the *ATS* and *D&S* cases were not identical. The ATS contract did not represent that the claim was undisputed. It also qualified some representations, such as its representation that the claim is not subject to any defense, claim or right of setoff, etc., with a seller's knowledge standard.

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(c) On appeal in *Enron Corp. v. Springfield Associates, LLC (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), the district court found a distinction between sales and assignments of claims and held that a personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but will not if the claim is *sold*.[11] The district court then remanded the case back to the bankruptcy court to decide whether a sale or assignment had occurred. The case subsequently settled, so no decision was reached.

2. Is *Enron II* still good law?

(a) Practitioners, scholars and the judiciary alike have all struggled to grasp the *Enron II* court's distinction between a sale and an assignment of a claim. The distinction has been labeled as a "novel distinction that flew against the long-standing interchangeability of these terms in legal practice."[12]

(b) In *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, however, Judge Sweet of the Southern District of New York, while evaluating whether the put right was triggered, adopted the reasoning of *Enron II*. On appeal, the Second Circuit had the opportunity, but did not address the merits of *Enron II.* As a result, *Enron II* remains a legal precedent in the Southern District of New York.

(c) In *In re KB Toys et al.*, Judge Carey asked the parties how to distinguish between a sale and an assignment. Neither party was able to articulate an acceptable answer. After some deliberation, Judge Carey rejected the *Enron II* distinction between a sale and assignment and instead followed *Enron I*, holding that disabilities travel with the claim.[13] As mentioned above, this decision was affirmed by the Delaware District Court and has been further appealed to the Third Circuit. One of the issues likely to be considered by the Third Circuit is whether, under New York law, there is a legally significant distinction between a sale and an assignment of a claim.

II. Trade Confirmations

A. Bank debt

1. General practice in both the U.S. and U.K. secondary bank debt and claims trading markets is that a trade is binding upon oral[14] or written agreement on material terms. In other words, "a trade is a trade." In a recent Fifth Circuit decision, an over-the-phone trade of bank debt was held as binding even though an email shortly after the call stated that the trade was "subject to appropriate consents and documentation." The Fifth Circuit reasoned that, because the parties' had previously entered into an LSTA trade confirmation on a prior trade, all of such parties subsequent bank debt trades with each other automatically incorporate the LSTA Standard Terms and Conditions, pursuant to paragraph 21 of the LSTA Standard Terms and Conditions.[15] Because the parties were bound to the LSTA Standard Terms and Conditions, the parties were obligated to demand or reserve any non-industry, non-LSTA terms or conditions explicitly during the telephone call, at the time of trade. Furthermore, the Fifth Circuit was not convinced that even the "subject to" email unambiguously raised non-industry terms

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[11] In *Enron II*, Judge Scheindlin distinguished between an assignment ("As Assignee stands in the shoes of the assignor and subject to all equities against the assignor. In other words, an assignee of a claim takes with it whatever limitations it had in the hands of the Assignor"), and a sale ("a purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor in certain circumstances"). *Enron II*, at 435-36 (internal quotes omitted).

[12] Adam J. Levitin, "Bankruptcy Markets: Making Sense of Claims Trading," 4 *Brook. J. Corp. Fin. & Com. L.* 67, 92 (2009).

[13] Judge Carey's decision was upheld by the Delaware District Court and the Third Circuit. See *In re KB Toys Inc., et al.*, Civ. No 12-716 (D. Del. entered Jan. 4, 2013); *In re KB Toys Inc.,* Case No. 13-1197 (3d Cir. Nov. 15, 2013).

[14] Under New York and English law, oral trades are binding as the statute of frauds does not apply to the assignment, sale, trade, participation or exchange of indebtedness or claims relating thereto under the Qualified Financial Contracts. *See* N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii).; s*ee also Bear Stearns Plc v. Forum Global Equity Ltd.* [2007] EWHC 1576 (Comm) (upholding the binding effect of a telephone conversation between traders agreeing to terms of a purchase of Parmalat notes).

[15] "By execution of a Confirmation incorporating by reference the Standard Terms and Conditions, each of Buyer and Seller agrees to be legally bound to any other transaction between them (whether entered into before, on or after the Trade Date) with respect to the assignment, purchase, sale and/or participation of commercial and/or bank par/near par loans, or any interest therein, upon reaching agreement to the terms thereof (whether by telephone, exchange of electronic messages or otherwise, directly or through their respective agents, and whether the subject of a confirmation), subject to all the other terms and conditions set forth in any confirmation relating to such transaction, or otherwise agreed." *Standard Terms and Conditions for Par/Near Par Trade Confirmations*, LSTA, at 13 § 21 (June 29, 2012).

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because "appropriate consents" could have arguably been a reference to borrower consent, a common requirement of assignments in LTSA trades that is nevertheless not a condition precedent to a binding agreement under the LSTA Standard Terms and Condition. Likewise, the "subject to . . .documentation" could have been a reference to the standard trade confirmation, again, not a condition precedent to a binding trade under LSTA Standard Terms and Condition. *See Highland Capital Management L.P. v. Bank of America, Nat. Ass'n*, 2012 W.L. 4498518 (5th Cir. Oct. 2, 2012).

2. However, New York case law considering the binding effects of an LSTA trade confirmation is undeveloped. Case law suggests that bank debt trade confirmation may be interpreted as an obligation to negotiate in good faith rather than a binding obligation to settle the trade, as in the bankruptcy claims trading context. In dicta, in a case that ultimately settled out of court, both a New York state trial court and appellate court appeared to consider the standard LSTA trade confirmation at issue as a preliminary agreement to negotiate in good faith as opposed to a requirement to settle (focusing on the "subject to" the "negotiation, execution and delivery of reasonably acceptable contracts and instruments of transfer" language in the trade confirmation). *See Credit Suisse First Boston v. Utrecht-America Finance Co.*, 80 A.D.3d 485 (N.Y. App. Div., 1st Dep't 2011); *Credit Suisse First Boston v. Utrecht-America Finance Co.*, No. 601123/2004, at 19-20 (Sup. Ct. N.Y., N.Y. Cnty. Feb. 3, 2010).

B. Bankruptcy claims

1. Trade confirmations and definitive documents are specifically tailored and heavily negotiated. Case law suggests that courts may view an email confirmation and phone calls as only a preliminary agreement to negotiate the settlement documents in good faith, rather than a binding commitment to settle the trade. *See also Bear Stearns Inv. Products, Inc. v. Hitachi Automotive Products (USA), Inc.*, 401 B.R. 598 (S.D.N.Y. 2009), where the seller, a trade creditor, agreed orally to sell its claims to the buyer and exchanged comments to definitive documentation, but subsequently sold to a third party. No trade confirmation was executed between the creditor and the buyer; the court thus held that the parties had not entered into a binding agreement but rather a preliminary agreement to negotiate in good faith.

2. The court further held that the putative buyer only had a right to demand that the seller negotiate the terms of the sale in good faith and that the question of whether the seller had acted in good faith was an issue for trial, not suitable for summary judgment. In making this determination, the court considered:

   (a) Whether there was express reservation of right not to be bound in the absence of a writing;

   (b) The context of the negotiations;

   (c) The existence of open terms;

   (d) Whether there was partial performance; and

   (e) The necessity of putting the agreement in writing.

3. Shortly after the court issued its opinion, the parties filed a stipulation dismissing the complaint.

C. After executing a trade confirmation

1. Parties are bound to the confirmation and its terms, but whether this obligates the parties to settle the trade or merely to continue to negotiate depends on contract law interpretation. A trade confirmation will not require the parties to settle when the parties do not express an intent to be bound and there is no event that would signify the acceptance of an offer.[16]

[16] *Compare Teachers Ins. and Annuity Ass'n. of Am. v. Tribune Co.*, 670 F. Supp. 491, 494 (S.D.N.Y. 1987) (in the writing expressly stated that upon execution of the letter "our agreement . . . shall become a binding agreement between us") *with Odgen Martin Systems of Tulsa, Inc. v. Tri-Continental Leasing Corp.*, 734 F. Supp. 1057, 1069 (S.D.N.Y. 1990) (finding no intent to be bound when "Odgen did not insert a *Tribune* type clause indicating an intent to be bound and TriCon did not disclaim any intent to be bound" and stating that "the presumption rests with an intent not to be bound given the open terms and the call for future approval of further contract negotiations").

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2. "Type I" preliminary agreement — A so-called "Type I agreement" is a binding contract on the underlying transaction.[17] LSTA Bank Debt trade confirms are likely to be considered Type I.[18] A Type I agreement is formed:

   (a) When all of the "contract terms" have been agreed to prior to the signing of the confirm; or

   (b) When there has been partial performance on the underlying transaction.

   Other factors to consider are:

   (c) Whether it is customary to formalize such an agreement in writing; and

   (d) Whether there is an express intention not to be bound in the absence of a formal writing.

3. "Type II" preliminary agreement — A "Type II agreement" is a binding preliminary agreement. In other words, it is an agreement to agree and to negotiate in good faith; parties may not unilaterally terminate negotiations.[19] Most bankruptcy claim trade confirmations are intended to be "Type II" agreements. Courts weigh the following factors to determine whether a Type II agreement has been formed:

   (a) Whether intent to be bound can be found in the language of the confirm;

   (b) Whether there has been partial performance;

   (c) The existence of open terms;

   (d) The context of previous negotiations; and

   (e) Whether the custom is to finalize such an agreement in writing, suggesting that it is not final in, and of, itself.

4. Good faith negotiation

   (a) Precisely what constitutes "good faith negotiation" is the subject of pending litigation relating to a recent transaction involving the purchase of a Madoff feeder fund's claim against the Madoff estate. *See Complaint, Kingate Global Fund Ltd. and Kingate Euro Fund Ltd. v. Deutsche Bank Securities Inc.*, No. 11-9364 (S.D.N.Y. Dec. 21, 2011). In its complaint, the plaintiff ("Kingate") alleges that it entered into a binding trade confirmation to sell to Deutsche Bank Securities ("DB") approximately $1.6 billion in claims against Bernard L. Madoff Investment Securities LLC. The relevant language in the subject trade confirmation states that it is a "confirmation of our firm, irrevocable and binding agreement (the "Transaction") to sell the Claims" but the confirmation also states that the "Transaction is subject to execution of a Purchase and Sale Agreement (governed by New York law) in a form that is reasonably and mutually agreed between the Seller and the Buyer and which the Seller and the Buyer shall negotiate in good faith." *See id.* at ex. 1. Kingate further alleges that DB's negotiations of provisions of the purchase and sale agreement and certain protections under the settlement agreement between Kingate and the trustee were motivated not by genuine concerns over the protections, but rather by a bad faith desire to avoid the transaction entirely, due to recent market rate declines in price for such claims.

   (b) Determining whether negotiations were conducted in good faith is a fact-specific analysis. There is no settled case law in the context of distressed bank debt or bankruptcy claims trades. Court decisions in the context of other contracts, however, provide illustrations as to the meaning of "good faith negotiations":

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[17] *Brown v. Cara*, 420 F.3d 148, 154 (2d Cir. 2005); *see also Tribune*, 670 F. Supp. at 498 (stating that in a Type I agreement, "the parties have reached complete agreement (including the agreement to be bound) on all the issues perceived to required negotiation").

[18] *But see Credit Suisse First Boston*, 80 A.D.3d 485 (N.Y. App. Div., 1st Dep't 2011); *Credit Suisse First Boston*, No. 601123/2004, (Sup. Ct. N.Y., N.Y. Cnty. Feb. 3, 2010) (discussed above).

[19] *See Brown*, 420 F.3d at 157; *Tribune*, 670 F. Supp. at 498.

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(1) In *Rus, Inc. v. Bay Industries, Inc.*,[20] the court held that not closing on a Stock Purchase Agreement due to a "unsatisfactory" environmental report (there was a requirement in the confirm of a satisfactory report) was a question for the jury, specifically whether a reasonable buyer would have been satisfied. So, even words like "satisfactory," which appear discretionary, can be burdened by the duty to negotiate in good faith;

(2) In *Simone v. N.V. Floresta, Inc.*,[21] the court found good faith as a matter of law due to evidence of extensive efforts to close despite the presence of deal-breaking terms in the confirm. It was a very fact-intensive inquiry and the decision was premised on the finding that the negotiation was working *toward* a formal contract and not trying to avoid one;

(3) In *Network Enterprises, Inc. v. APBA Offshore Production, Inc.*,[22] the court found that there was a preliminary agreement and a duty to negotiate in good faith despite the fact that the producer reserved the right to unilaterally withhold consent with regard to broadcast dates. The court found that using that right as a negotiating tool was bad faith and the network was entitled to damages for the underlying transaction; and

(4) In *Teachers Ins. and Annuity Ass'n of Am. v. Tribune Co.*,[23] the court found that the borrower was not negotiating in good faith when, after execution of the confirm, it insisted on adding a new condition (i.e., satisfactory accounting treatment) to the further negotiations of a loan. Introducing a new material term, even if reasonable, can be bad faith.

III. When Must a Bank Debt Seller Settle Its Trades?

A. LSTA Standard Terms and market practice do not require settlement of a distressed bank debt trade by a specific time.

LSTA Standard Terms and Conditions for Distressed Trade Confirmations ("Standard Terms") specify that "The transfer of the Purchase Amount [ ] of the Debt [ ] specified in the Confirmation shall be effected *as soon as practicable* on or after the Trade Date. Any alternative agreement between Buyer and Seller as to a targeted date of settlement shall be specified in the Confirmation."[24]

B. The meaning of "as soon as practicable" depends on the facts and circumstances of the trade.

1. The New York Supreme Court recently interpreted this provision in *Goldman Sachs Lending Partners, LLC v. High River L.P.*, 34 Misc. 3d 1209(A), 943 N.Y.S.2d 791 (Sup. Ct. 2011). High River Limited Partnership ("High River") had agreed to sell $140 million of Delphi bank debt to Goldman Sachs Lending Partners ("GS"). High River was selling the debt short. After the trade date, a new entity owned by a group of DIP lenders announced a rights offering. GS communicated to High River that it expected High River to settle the trades before the record date for the rights offering. High River, however, ignored GS and did not settle the trades before the record date.

2. The New York Supreme Court held that under these circumstances, "as soon as practicable" means as soon as feasible, or speedily. Under the Standard Terms, "settlement of the Trades by the Record Date was essential."[25] It therefore found that High River had breached the contract.[26]

C. Implications for practice

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[20] 322 F. Supp. 2d 302, 315 (S.D.N.Y. 2003).

[21] 1999 WL 429504, 1999 U.S. Dist. LEXIS at *24-25 (S.D.N.Y. June 18, 1999).

[22] 427 F. Supp. 2d 463, 486 (S.D.N.Y. 2006).

[23] 670 F. Supp. at 507-08.

[24] *Standard Terms and Conditions for Distressed Trade Confirmations*, LSTA, at 1 § 1 (Sept. 9, 2011) (italics added).

[25] *Goldman Sachs Lending Partners, LLC v. High River L.P.*, 34 Misc. 3d 1209(A), 943 N.Y.S.2d 791, at 15 (Sup. Ct. 2011).

[26] High River appealed the trial court decision on Jan. 23, 2012, but the appeal was withdrawn on Feb. 6, 2014.

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1. A buyer's settlement expectations and the facts surrounding the credit that is the subject of the trade may impose a duty to settle by a specific time. Sellers should be aware that they may be required to settle trades by a specific date due to developments arising after entry into the trade, even if the trade confirmation fails to include a deadline.

2. Sellers also may be obligated to attempt to settle trades prior to a fact-specific deadline. One important reason why the court found High River liable was that the trades did not settle *because* of the acts and omissions of High River. High River never owned any Delphi bank debt and never even attempted to purchase any to settle the trade. Although it is unclear whether it would have been possible for High River to buy and settle sufficient amounts of the debt prior to the record date, the fact that High River exerted no effort to settle the trade made it clear to the court that High River had failed to fulfill its fundamental obligation to proceed in good faith to settle the trade.

D. Does a buyer of bank debt acquire the right to participate in a rights offering if that right is not specified at the time of trade?

1. The LSTA Standard Terms state, "If a commitment is indicated, Buyer is assuming all unfunded commitments relating to the Purchase Amount of the Debt unless otherwise specified in the Confirmation. Unless otherwise specified in the Confirmation, Buyer is assuming the obligation to purchase . . . the Debt as such Debt may be reorganized, restructured, converted or otherwise modified."[27]

2. Under the LSTA Purchase and Sales Agreement Standard Terms and Conditions for Distressed Trades, "Transferred Rights"[28] do not expressly refer to rights offerings.[29]

3. When rights offerings have been announced after a trade date, market practice has been for the seller and buyer to negotiate a side letter agreement in which the buyer contracts for the seller to subscribe to the offering on the buyer's behalf. Depending on the relative leverage of the parties, the buyer may pay for such subscription prior to any funding deadline and typically indemnifies the seller for its actions on behalf of the buyer.

4. In *Goldman Sachs Lending Partners, LLC v. High River L.P.*, GS sent High River a draft letter agreement, but High River refused to negotiate or sign the agreement. The damages awarded to GS resulting from High River's failure to subscribe to the rights offering on behalf of GS imply that the buyer is entitled to receive the proceeds of a rights offering, even if the offering is not part of the debtor's plan at the time of entry into the trade. The fact that the market price of the bank debt (around 56 cents on the dollar) was significantly higher than the distributions from the debtor (approximately 16 cents per dollar) indicates that the secondary market was treating the rights offering as part of the bank debt.

E. Distressed Buy-In/Sell-Out

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[27] *Standard Terms and Conditions for Distressed Trade Confirmations*, LSTA, at 1 § 2 (Sept. 9, 2011).

[28] "Transferred Rights" are defined to mean any and all of Seller's right, title and interest in, to and under the Loans and the Commitments (if any) and, to the extent related thereto, the following (excluding, however, the Retained Interest (if any)): (a) all other amounts (including any PIK Interest) funded by or payable to Seller or any Prior Seller (if any) under the Credit Documents, and all obligations owed to the Seller or any Prior Seller in connection with the Loans and the Commitments (if any); (b) the Credit Documents; (c) the Proof of Claim (if any); (d) the Predecessor Transfer Agreements (if any) (but only to the extent related to the Loans or the Commitments (if any), as specified in the Annex); (e) all claims (including "claims" as defined in Bankruptcy Code §101(5)), suits, causes of action and any other right of the Seller or any Prior Seller, whether known or unknown, against the Borrower, any Obligor, or any of their respective Affiliates, agents, representatives, contractors, advisors or any other Entity that in any way is based upon, arises out of or is related to any of the foregoing, including, to the extent permitted to be assigned under applicable law, all claims (including contract claims, tort claims, malpractice claims and claims under any law governing the purchase and sale of, or indentures for, securities), suits, causes of action and any other right of Seller or any Prior Seller against any attorney, accountant, financial advisor or other Entity arising under or in connection with the Credit Documents or the transactions related thereto or contemplated thereby; (f) all Guaranties and all Collateral and security of any kind for, or in respect of, the foregoing; (g) all cash, securities, or other property, and all setoffs and recoupments, received, applied, or effected by or for the account of Seller or any Prior Seller under the Loans or the Commitments (if any) and other extensions of credit under the Credit Documents (whether for principal, interest, fees, reimbursement obligations or otherwise) from and after the Trade Date (unless excluded pursuant to Section 8.1), including all Distributions obtained by or through redemption, consummation of a plan of reorganization, restructuring, liquidation or otherwise of the Borrower, any Obligor or the Credit Documents, and all cash, securities, interest, dividends and other property that may be exchanged for, or distributed or collected with respect to, any of the foregoing; (h) the economic benefit of permanent commitment reductions, permanent repayments of principal and Non Recurring Fees received by the Seller or any Prior Seller from and after the Trade Date; and (i) all proceeds of the foregoing.

[29] *But see In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008) (holding that broad definition of "Transferred Rights" included certain reimbursement rights granted to the original lenders under the final cash collateral order).

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1. In September 2011, the LSTA Distressed Buy-In/Sell-Out ("Distressed BISO") went into effect. Distressed BISO is intended to give a performing party leverage over a non-performing trade counterparty in order to move a stalled trade toward settlement. Distressed BISO established 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. No party is intended to profit from Distressed BISO, which merely seeks to put each party in the same economic position as it would be in if the trade had settled.

2. Even if the trades at issue in the *High River* case had been subjected to Distressed BISO, the outcome likely would have been the same. First, GS would not have been able to rely on Distressed BISO because the Record Date was less than the required 50 days after the Trade Date, after which a party could have triggered Distressed BISO. Second, even had the Trade Confirmations been subject to Distressed BISO and the Record Date had been after the Distressed BISO trigger date, then High River, as a short seller, who did not enter into a buy trade within T+5, could not rely on its open upstream trades to shield itself from a buyer's Distressed BISO notice.

IV. Purchasing Claims from Bankruptcy Estate or Liquidator — The New "363" Sale

A. Circumstances may require court approval before the trade confirmation becomes binding on the seller.

1. Asset sales by Chapter 11 debtors or bankruptcy trustees or liquidators are typically required to be conducted in a manner that achieves the best price for the assets in order to maximize recovery to the estate's creditors. This usually requires a demonstration by the seller that the asset, e.g., a claim, has been effectively marketed, and often an auction process. If a buyer is considering making a bid on such a claim as the stalking horse bidder, it should consider requiring the seller to seek court-approved bidding procedures and a break-up fee.

2. In a recent bankruptcy claim trade involving a Madoff feeder fund subject to BVI liquidation proceeding and a corresponding Chapter 15 case in the United States, the feeder funds' liquidator entered into a trade confirmation to sell its Madoff claims to an investment fund. The market value of the claims increased significantly just a few days after the liquidator executed the trade confirmation on behalf of the feeder fund. The liquidator filed papers asking the U.S. court to *disapprove* the trade, arguing that as the claim is substantially all of the estate's assets, selling it is "outside the ordinary course of business" within the meaning of Section 363 of the U.S. Bankruptcy Code. Judge Lifland viewed the liquidator's attempt as "a pure and simple case of seller's remorse" and declined to disapprove the trade on the basis that a Section 363 review was not warranted because the sale did not involve the transfer of interest in property within the United States, but rather, under New York law, the Madoff SIPA claim is an intangible asset located in BVI.[30] Although the foreign liquidator's efforts to unwind the trade failed in this instance, the implication of the decision could be that all claims purchased from a U.S.-based Chapter 11 bankruptcy estate could be subject to court approval and/or public notice and hearing. Additionally if such U.S.-located claims are subject to court approval, under past Ssection 363 decisions[31] it may be subject to disapproval on the basis of a higher and better offer, of not being an exercise of sound business judgment or as not being in the best interests of creditors.

B. Application for bankruptcy claim investors

1. Know your counterparty — Is it insolvent or subject (or potentially subject) to any type of insolvency, receivership, or bankruptcy proceedings, keeping in mind that U.S. proceedings may require additional steps in order to comply with Section 363?

2. Know the approvals required — Understand and clearly state in the trade confirmation required approvals to bind your seller. Approach the trade in the same manner as a distressed asset purchase by a stalking horse bidder:

   (a) Employ market standard bid protections (break-up fee, minimum over bid amounts, defined qualified bidder and qualified bid, and expense reimbursement);

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[30] *In re Fairfield Sentry Ltd. et al.*, 10-13164 (Bankr. S.D.N.Y. entered Jan. 10, 2013).

[31] *See e.g., In re Mataldyne Corp.*, 409 B.R. 661 (Bankr. S.D.N.Y. 2009), *In re Innkeepers USA Trust*, 442 B.R.227 (Bankr. S.D.N.Y. 2010).

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(b) Seek approval of bid procedures and bid protections from each necessary court; and

(c) Include milestones for counterparty to obtain approval and close transaction within certain timeframe.

3. Any such sale and all its terms are likely to be public.

(a) Courts have generally been unwilling to allow bids and sale terms for a debtor's assets to be filed under seal.

(b) Competing bids and an auction itself are generally, though not universally, non-public. In such cases, competing bids received prior to an auction are typically only viewed by the debtor and a select group of interested parties. If there is an auction, each qualified bidder participates and can see other bids, but only the winning bid is publicly disclosed as part of the sale approval process.

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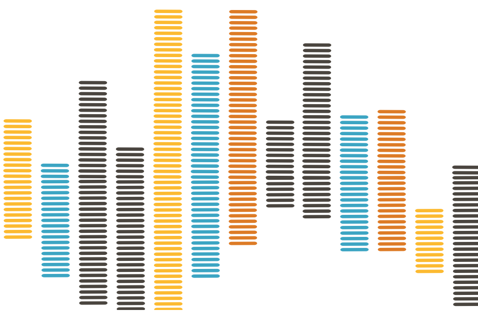

Overview of European Claims Trading

6. Additional Materials

Popularity of UK Scheme of Arrangements to Restructure Foreign Companies Continues — Boundaries of Application Further Extended

Alert

Popularity of UK Scheme of Arrangements to Restructure Foreign Companies Continues — Boundaries of Application Further Extended

1 May 2014

The English Cases — Further Extension of UK Scheme of Arrangement for the Benefit of Foreign Companies

Two recent cases signpost the continued preparedness of English courts to extend the boundaries of the applicability of the UK Scheme of Arrangement to come to the aid of restructuring foreign companies. These recent decisions indicate the continued pragmatic approach of the English courts in applying the touchstones[1] for invoking the jurisdiction of the English courts to sanction a restructuring compromise in respect of a foreign company or group of foreign companies under a UK Scheme of Arrangement. Helpful further guidance is also provided on the grouping of classes of creditors for voting purposes in the context of a UK Scheme of Arrangement. This *Alert* considers those two recent cases.

The predictability of application of the law, as evidenced by these English court decisions, as well as the recognition of the UK Scheme of Arrangement by the US Bankruptcy Courts, will be sure to result in the continued use of the UK Scheme of Arrangement by foreign companies in situations where a dissenting minority of creditors may otherwise frustrate a restructuring proposal that is in the interests of the company and its creditors as a whole. Ultimately, the growing availability of the UK Scheme of Arrangement as an option for restructuring a foreign company will be useful as a negotiating tool in avoiding local value-destructive formal insolvency filings that do not sufficiently cater for a rescue.

Invoking Jurisdiction of the English Court Through the 'Back Door'

The not insignificant number of UK Scheme of Arrangement decisions rendered in respect of foreign companies has established the principle that a company has 'sufficient connection' to invoke the jurisdiction of the English court under a UK Scheme of Arrangement if the finance documents to which it is subject and in respect of which the restructuring is proposed are governed by English law and subject to the jurisdiction of the English courts.[2] The novel feature of the *Apcoa* case[3] was the route to obtaining this 'sufficient connection'. At the time that *Apcoa*'s restructuring was being mooted, its finance documents were governed by German law and subject to the jurisdiction of the Frankfurt Courts. The

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[1] A UK Scheme of Arrangement will only be sanctioned by the English court if the court is satisfied that it has jurisdiction. There are, in short, two limbs to satisfying the jurisdiction test. The first limb is that the company is of the type that is liable to be wound-up under the Insolvency Act 1986, and the second limb is that the English court is sufficiently comfortable that its order sanctioning the scheme will have effect in the relevant foreign jurisdiction(s) (i.e., through formal recognition or otherwise). As regards the first limb, this has been interpreted widely as meaning that the company must have a 'sufficient connection' to the English jurisdiction [*e.g., Re Rodenstock GmbH* [2011] EWHC 1104 (Ch)].

[2] *Re Rodenstock GmbH*; *Re Drax Holdings Ltd* [2003] EWHC 2743 (Ch).

[3] *Re APCOA Parking (UK) Ltd & Ors* [2014] EWHC 997 (Ch) ('*Apcoa*'), as well as the sanction decision (although at the time of this writing, the 14 April 2014 sanction decision was not yet published).

parent company was German, its COMI[4] was Germany, and it, together with various of its European subsidiaries, was an obligor under the finance documents. There was, at this time, no material connection to the English jurisdiction.

To successfully restructure the *Apcoa* group's liabilities, and avoid the German parent filing for insolvency, it was proposed that the maturity date of the finance documents be extended (the 'Proposal'). Unfortunately, the terms of the finance documents required the consent of 100 per cent of the finance parties for this particular amendment to be effected and, whilst there was every confidence that an overwhelming majority would be in favour, it was clear that a small minority would not agree. Unlike the UK Scheme of Arrangement, German law does not provide a statutory regime outside of formal insolvency proceedings overriding contractual terms, so as to allow a requisite majority to bind the dissenting minority to a restructuring compromise proposal, if the contractual documents do not allow it. The proponents of the Proposal thought that if *Apcoa* could somehow avail itself of the UK Scheme of Arrangement, the Proposal would successfully be effected, notwithstanding the terms of the finance documents to the contrary, since, under the UK Scheme of Arrangement, the consent of only 75 per cent in value of each affected class of creditors would be required. *Apcoa* sought to invoke the jurisdiction of the English courts under the 'sufficient connection' limb by proposing and successfully procuring an amendment under the relevant finance documents of the governing law from German law to English law and the jurisdiction clause from Frankfurt courts to English courts. It has elsewhere been reported that, under the terms of the finance documents, the consent of only two thirds of the finance parties was required for an amendment to the governing law and jurisdiction clauses. This consent was duly obtained by way of formal amendment under the terms of the finance documents. The court's reasoning will become evident once the sanction hearing decision is published as well. But it is anticipated that, in seizing jurisdiction, the court would have considered that this route to finding jurisdiction, although novel, was not such an extension of existing principle as to be inconsistent with it or objectionable.

It is understood that in deciding to sanction the UK Scheme of Arrangement under the second limb of the touchstone, the court relied on the following points: the strong support of the creditors at the scheme meeting, as well as the expert legal opinions in each relevant foreign jurisdiction that the amendment under the relevant finance documents changing the governing law and jurisdiction clauses had been properly effected and that the Proposal would be given effect in the jurisdictions of the relevant obligors. In addition, evidence was adduced that at the time the amendment to the governing law and jurisdiction clauses were being considered, creditors had been advised that this was being proposed for the purpose of possibly undergoing a UK Scheme of Arrangement.

Classes – What Comprises 'Common Interests'?

Another development in *Apcoa* worth highlighting is the court's decision to rule that two differently *ranked* classes of creditors could vote under the Proposal as a single class. Whilst the court noted that the different rankings suggested the creditors had different interests, thereby requiring separate classes for voting on the Proposal,[5] the court considered that this was not determinative of the issue and that other factors may point to their common interests. In this case, the court held that there were more important common interests requiring the finance parties to vote as a single class under the Proposal.

[4] COMI is an acronym for 'centre of main interests'. COMI determines the international jurisdiction for the opening of primary insolvency proceedings for the company (as per Article 3 of the EC Regulation on Insolvency Proceedings 2000).

[5] Creditors whose rights are so dissimilar as to make it impossible for them to consult together with a view to their common interest are required to vote in separate classes [*Apcoa*].

These common interests included that under a German insolvency analysis (being the likely alternative to the Proposal) the different rankings of the creditors would not be recognised. Another factor was that the Proposal would affect all the creditors equally.

Sufficient Connection — Change of COMI

In *Magyar*,[6] the English court again sanctioned a UK Scheme of Arrangement restructuring debt obligations issued by a foreign company — in this case, a Dutch company. This time, the 'sufficient connection' was held to be that the Dutch company's COMI was England. This fact alone was determined by the court to be a sufficient connection and enough to outweigh the facts that the debt obligations were governed by the law of the State of New York and were subject to the non-exclusive jurisdiction of the courts of the State of New York. The fact that the debtor had recently changed its COMI from the Netherlands to England with the specific intention of establishing jurisdiction in order to sanction a UK Scheme of Arrangement was considered by the court not to be a barrier in this context.[7]

In sanctioning the UK Scheme of Arrangement under the second limb, the court in *Magyar* heard expert evidence from New York and Dutch lawyers (amongst others) to the effect that the UK Scheme of Arrangement would be recognised in those jurisdictions. In addition, it was held that the Scheme was entitled to recognition and enforcement under Chapter III of Council Regulation (EC) No 44/2001 (the 'Judgments Regulation'), which regulates the implementation and enforcement of judgments in civil and commercial matters in EU member states (except Denmark).

This case provides further evidence of the court's preparedness to interpret narrowly the rule against 'forum shopping' as set out in recital 4 of the EC Regulation on Insolvency Proceedings 2000. In broad terms, the rule against forum shopping is intended to prevent companies from changing their COMI with a view to avoiding the consequences of the insolvency law regime in the former jurisdiction and to avail themselves instead of the insolvency law regime of the chosen jurisdiction – that being the jurisdiction to which it has changed its COMI.

Recognition of UK Scheme of Arrangement as 'Foreign Main Proceedings' Under Chapter 15, US Bankruptcy Code

In the *US Magyar* case,[8] the company sought an order recognising the English proceedings as 'foreign main proceedings' under the US Bankruptcy Code in order to facilitate its restructuring under a UK Scheme of Arrangement. This was the first time a US Bankruptcy Court granted, in respect of a UK Scheme of Arrangement, Chapter 15 bankruptcy protection. Its order enjoined noteholders under the company's New York law-governed notes from commencing enforcement proceedings.

In arriving at its decision, the US court noted that the UK Scheme of Arrangement could not have been successful unless the Chapter 15 ruling was made since, otherwise, noteholders would have been at liberty to sue the obligors in the United States, thereby undermining the UK Scheme of Arrangement. Following precedent, the US court said that the test for recognition of 'foreign main proceedings' should simply be whether the foreign order should be enforced in the United States. The US court considered that the English proceedings in respect of the UK Scheme of Arrangement were fair and protected creditors' best interests and were not contrary to US public policy.

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[6] *Magyar Telecom B.V.* [2013] All ER (D) 20 ('*Magyar*').

[7] Another recent UK Scheme of Arrangement decision that also dealt with a similar COMI shift is *In the Matter of Zlomrex International Finance S.A.* [2013] EWHC 4605 (Ch), where the COMI of a French company in a Polish group was changed to the UK.

[8] *In re Magyar Telecom B.V.*, Case No. 13-13508 (SHL) (Bankr. D. Del. Dec. 12, 2013) (the '*US Magyar* case').

The significance of the *US Magyar* case is the US Bankruptcy Court's recognition of the UK Scheme of Arrangement as an 'insolvency proceeding' to which Chapter 15 relates. The UK Scheme of Arrangement is a court-supervised restructuring tool which functions under the Companies Act 2006 (UK) (not the Insolvency Act 1986 (UK)) and can apply equally to solvent reorganisations as well as to insolvent reorganisations. In the case of *Magyar*, the reorganisation was being pursued under a solvent reorganisation.

Conclusion

The continued extension of the application of UK Schemes of Arrangement to foreign companies, along with the wide variety of restructurings available under it, and the consistently pragmatic approach adopted by the English courts in that context, will together continue to ensure the UK Scheme of Arrangement is seen as a restructuring tool of choice for UK and foreign companies alike and their creditors in cross-border situations.

Authored by Sonya Van de Graaff and Peter J.M. Declercq.

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

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Transfer Restrictions May Create Additional Counterparty Risk for Distressed Debt Investors

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Author David J. Karp and Anthony Lombardi

Transfer restrictions may create additional counterparty risk for distressed debt investors

KEY POINTS

- Borrowers are pushing origination banks to tighten transferability language and extend their consent right to include participations and other types of transfers.
- A borrower may have regard to maintaining "control" over its lender group when withholding consent to a debt transfer.
- European loan traders must actively manage borrower consent and settlement risk on a case-by-case basis.

Experienced European loan traders know that borrowers and sponsors may be concerned about perceived "aggressive" investment funds buying into their debt, either directly or via sub participations. As a result, when European borrowers receive a request for an investment fund to enter their lender group via a secondary market transfer, they are increasingly using their consent rights to deny the request and maintain control of the make-up of the group. In many cases, the loan agreement requires the borrower not to unreasonably withhold consent to the transfer; but what constitutes "consent being unreasonably withheld" is an unsettled point of English contract law, which governs many loan agreements across Europe. Further, borrowers are pushing for a tightening of the transferability language and extension of their consent right to include participations or other types of "transfers", potentially further clouding how a secondary market trade will settle.

In many instances, a buyer will confirm a bank debt trade prior to understanding the transfer risk on a particular name. What happens when a fund confirms its purchase of bank debt and the borrower subsequently withholds its consent for the fund to become a lender of record? The fund may be forced to settle by participation which, in Europe, is structured as a derivative relationship. In this context, the seller is delivering an unsecured claim to a buyer against the seller referencing the underlying borrower and lender relationship. In contrast, the US form of "true participation" is intended to vest the buyer with an ownership right in the proceeds the lender paid to the borrower and then passed them to the participant. European loan traders need to be cautious as they are more likely to end up as a participant due to consent being withheld by a borrower, which results in:

- double credit risk (from the seller and the borrower);
- no privity with the borrower or ability to be active in a restructuring; and
- a potentially less-liquid position than being in senior secured bonds or, for that matter, a lender of record.

STATUS OF PARTICIPATIONS IN UK V US (LMA V LSTA)

The Loan Market Association (LMA) and Loan Syndication and Trading Association's (LSTA) mandatory settlement provisions dictate that if a trade cannot settle by legal transfer, there will be an automatic "fall-back" to settlement via funded participation or other economic equivalent.

LMA participations

The LMA form of funded participation is governed by English law and contemplates a debtor/creditor relationship between the seller (grantor) and buyer (participant). Under this type of arrangement, the buyer has no beneficial interest in the underlying loan agreement, nor any relationship with the borrower. Instead, the buyer has only a right to receive the economic equivalent of any payments made by the borrower under the loan agreement to the seller, with the seller passing on such amounts to the buyer pursuant to the terms of the participation agreement. As the participant (the buyer) has no interest in the underlying debt or loan agreement, it has no contractual standing against the borrower if the borrower defaults under any of its payments. Additionally, the buyer also bears credit risk exposure against the seller, should the seller become insolvent during the life of the participation. In such a scenario, the buyer only has an unsecured claim against the seller under the funded participation and cannot claim a proprietary interest or entitlement in, or to, the underlying loan proceeds or security granted under the loan agreement. The result of this structure for the buyer is a "double credit risk" scenario, placing the buyer in an inherently more risky position than if it were to become a lender of record or if it had acquired the bank debt by way of an LSTA "true participation" arrangement.

For many investors, the increased counterparty credit risk, decreased control and decreased liquidity resulting from an LMA funded participation is enough to ruin the investment – and the trade has not even yet settled.

LSTA participations

The LSTA form of funded "true participation" is a New York law governed structure, intended to give the buyer an ownership interest in the actual proceeds paid by a borrower to the seller. Whether a participation constitutes a "true participation" under New York law is a fact-based analysis that takes into account various factors including:

- the relevant language of the underlying agreement;
- the amount of control the seller retains or is perceived to retain over the assets after the closing of the relevant transaction; and
- whether the transaction shifts the risks of

Biog box

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loss and/or benefits of ownership to the transferee.

The LSTA form intends to meet this criteria and assign to the participant all of the rights of the grantor to payment under the loan agreement. In the event that the grantor becomes subject to insolvency proceedings, payments are intended to be isolated from its insolvency estate, resulting in more limited counterparty credit risk for a participant under a "true participation."

This LSTA true participation structure was recently tested and proven effective in the Chapter 11 case of *Lehman Brothers Commercial Paper*, when the Bankruptcy Court issued an order establishing that "all cash, securities and other property distributed or payable in respect of true participations… are not property of the debtor's estate and shall be promptly turned over to the beneficial holders thereof". LMA participants were not granted the same protection. (See *In re: Lehman Commercial Paper Inc, 08-13900* (SDNY Oct 6, 2008) (Order Pursuant to ss 105(a), 363(b), 363(c), and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing Debtor to (A) Continue to Utilize its Agency Bank Account, (B) Terminate Agency Relationships)).

"A TRADE IS A TRADE"

Investors should be especially cautious regarding the purchase of bank debt because the general practice in both the US and UK secondary bank debt and claims trading markets, is that a trade is binding upon oral or written agreement on material terms. (See N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii), and the recent UK decision of *Bear Stearns v. Forum Global Equity* [2007] EWHC 1576 (Comm), in which the court confirmed the binding nature of a telephone conversation between traders agreeing to terms of a purchase of *Parmalat* notes.) In other words, "a trade is a trade". The risk for an investor is that if you are forced to settle by way of participation, you will not end up with what you thought you originally agreed.

BORROWER WITHHOLDING CONSENT

In 2014, borrowers are taking more aggressive steps, not only to control their lender group, but other forms of economic participations and voting rights. While many loan agreements stipulate that borrower consent cannot be "unreasonably withheld", the historic lack of case law establishing what constitutes "unreasonable" behaviour in a commercial context leaves investors unsure as to whether they have legitimate grounds for challenging a borrower's refusal of consent.

A recent UK case – in which a potential borrower sued Terra Firma Capital Partners (the private equity owners of Tank & Rast Holding GmbH, a German infrastructure group) in the High Court for denying borrower consent to a competitor to whom Terra Firma did not want to provide access to syndicate confidential information – was unfortunately settled out of court without any guidance from the High Court on whether Terra Firma had legitimate grounds to withhold consent. However, in the recent decision of *Commercial First Business Limited v Anthony Henry Atkins* [2012] EWHC 4388 (CH) , the High Court reiterated the guidelines for determining whether consent had been unreasonably withheld (these guidelines were also followed in *Porton Capital Technology Funds and others v 3M UK Holdings Ltd and 3M Company* [2011] EWHC 2895 (Comm))

Applying these guidelines to secondary bank debt transactions, where borrower consent is withheld and subsequently challenged as being unreasonable, the following approach may be used by the courts when making a determination:

- the burden is on the proposed new lender to prove that withholding of consent by a borrower was unreasonable;
- a borrower does not need to show that its refusal of consent was right or justified, simply that it was reasonable in the given circumstances;
- in determining what is reasonable, the borrower may have regard to its own interests;
- a borrower with consent rights is not required to balance its own interests with those of the proposed new lender, or to have regard to the costs that the proposed new lender might be incurring.

While there is still little case law on this approach, the findings in *Porton* and *Commercial First* merit attention from the bank debt community as to difficulty around challenging borrower consent refusals for an English law governed loan agreement. If borrower consent is not obtained, the assignee will often rely on settlement via participation, sub-participation or some other alternative mutually agreed-upon structure, the pitfalls of which are discussed above.

"If borrower consent is not obtained, the assignee will often rely on settlement via participation, sub-participation or some other alternative mutually agreed-upon structure"

INVESTOR TAKE-AWAYS

While investors can attempt to negotiate additional terms at the time of trade, that enable them to walk away from a trade if legal transfer cannot be effected, this will likely be met with significant resistance and difficult to achieve as standard operating procedure. Alternatively, if the overall aim is to take on larger bank debt exposure against a particular borrower, it may be best to commit to a minimum threshold piece first, as a way to discern how easily it can settle the trade by way of legal transfer rather than by way of participation. However, it is important to note that in many European loan agreements , an existing purchase does not grant lenders an automatic right to increase their position and bypass borrower consent. Ultimately, like many European trade issues, borrower consent risk needs to be actively managed on a case-by-case basis. It is crucial for investors to begin to address this issue before saying "done" or they will be fighting an even steeper uphill battle with both their counterparty and the borrower. ■

Restructuring Structured Deals

SONYA VAN DE GRAAFF PARTNER, LONDON OFFICE, SCHULTE ROTH & ZABEL

Restructuring structured deals

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Since the credit crisis began in 2008, it has become cliché to note that many transactions have not been operating as intended, resulting either in superficial amendments (designed to achieve short-term fixes) or, in some cases, fundamental restructurings altering the substance of the transaction as originally conceived. Restructurings in the latter category of certain English law structured finance transactions have recently resulted in meaningful benefits to stakeholders.

The scenario being examined here involved an English law RMBS (Residential Mortgage Backed Securitisation) transaction where the issuer's swap counterparties filed for insolvency during the course of the transaction. On the issuer's termination of the swap contracts, it was substantially "in the money" and, therefore, had a sizeable claim in the insolvent estates of the counterparties.

Eventually, this resulted in significant lump-sum payments by way of dividend made to the issuer by the insolvent estates of the counterparties. The question, therefore, arose as to what the issuer should do with the proceeds. Although the transaction documents contemplated the eventuality of the swap termination, they failed to do so adequately or on terms acceptable to the stakeholders who were economically affected by the swaps terminating.

Specifically, the transaction documents in question required the issuer to apply the proceeds of the claim to buy a "replacement swap"; but, due to the prevailing market (and notwithstanding the payment of sizeable dividends), the proceeds of the claims were inadequate to purchase a replacement on commercially acceptable terms or for the entire duration of the RMBS transaction.

The purpose of this article is to examine what tools were used and what tools are available to effect a restructuring in such circumstances.

Where to start?

The starting point in assessing the options is the terms of the transaction documents themselves. The next step is to enquire, in the absence of adequate terms in the transaction documents, what tools can English corporate or insolvency law provide to assist in achieving an acceptable result.

One of the underpinnings of English law is that parties have (within reason) freedom of contract, and may agree amongst themselves upon amendments to transaction documents.[1] In most English law note documents, the terms of the notes themselves provide mechanisms by which noteholders may initiate amendments to the transaction. Whether by requisite majority of noteholders in value (usually at least two-thirds or three-quarters) at a meeting of noteholders with a requisite minimum quorum, or unanimously by way of a written resolution, noteholders may agree that the terms of their notes may be amended).[2] In the scenario being examined, noteholders availed themselves of these contractual provisions and initiated unanimous written resolutions instructing the trustee to request the issuer to agree upon amendments to the terms of the notes. The instructions were to request the issuer to do the following:

1. use the proceeds of the claims, not in buying a "replacement swap," but rather in application to the classes of noteholders themselves in a one-time agreed payment waterfall;
2. at the same time, the tranches of notes affected by the swap termination were redenominated (by way of a pool factor change) so as to eradicate the need for a currency swap going forward; and
3. to counterbalance the balance sheet impact to the issuer of the redenomination, the principal amount outstanding of the other tranches was reduced.

Building consensus

To effect these particular amendments (in addition to obtaining the agreement of the issuer), the agreement of the other secured creditors (comprising the various service providers to the transaction) was also required due to technical consequential changes that were required to be made to their service agreements.

Thanks to the commercial "common sense" of these parties, their consent was freely forthcoming and the amendments were effected without undue protraction. At the same time, the noteholders seized the momentum created by the situation to facilitate certain credit enhancements to the transactions so as to re-tranche the notes, thereby improving the ratings. Such amendments have been beneficial to all parties involved.

What happens if consensus cannot be achieved?

Although by no means straightforward, due to its consensual nature, the above factual scenario describes an ideal restructuring. But, had consensus not been freely forthcoming what problems might have arisen and what tools could have assisted?

Can consensus be compelled under the contractual provisions?

The first step is to scour the contractual documentation for provisions that might assist in compelling consent. In the case of structured finance documentation, it is not unusual to find provisions which, at least on their face, grant the trustee powers, on the instructions of the noteholders, to make amendments on behalf of the other secured creditors if such amendments cannot be regarded as being "materially prejudicial" to them. In a situation where the economic effect of the amendments affect only the noteholders, it may be possible to convince a trustee to invoke its powers under such a provision.[3]

General legal principles, such as that a party to a contract has no right to withhold its consent to amendments in bad faith or arbitrarily, come to the aid of a trustee and noteholders in such circumstances.[4]

Trigger an event of default to invoke enforcement rights?

Another avenue to consider is invoking and seeking to control enforcement rights. In the scenario described, if evidence could have been adduced that the insolvency of the swap counterparties prejudiced the transaction to the point of causing a consequential insolvency of the issuer, there might have been grounds to assert a transaction default. This assertion will be more difficult in long-dated securities (such as in standard RMBS transactions) than in short-dated maturities (such as CMBS (Commercial Mortgage Backed Securitisation) transactions). The English Supreme Court recently held that, given the variables (such as interest rates, currency fluctuations and other performance factors) that come into play during the term of a complex structured finance transaction with a long-dated maturity, so-called "balance sheet insolvency"[5] will be difficult to establish.[6]

In addition, careful analysis of any so-called "bankruptcy remote" provisions, usually found in structured finance transactions, will also be required. It may be that, on a proper analysis, the bankruptcy remote clauses prevent the invoking of an insolvency event of default. However, the English High Court recently ruled[7] that the inclusion of a "standard" bankruptcy remote clause in transaction documents did not prevent the SPV (Special-Purpose Vehicle) issuer properly being regarded as insolvent and provisional liquidators being appointed over the SPV issuer.

Scheme of Arrangement may be an option?

Perhaps less dramatic than agitating for an event of default, a creditor may consider invoking Part 26 of the Companies Act 2006 scheme of arrangement provisions. These involve a creditor making an application to court to summon a meeting of the relevant class of creditors to consider amendments to the transaction or restructuring the company. If the company and more than three-quarters of the creditors in the affected class (and who are also at or above the fulcrum[8] part of the capital structure) agree, the change will be effected notwithstanding that the transaction documentation does not expressly accommodate amendments by way of a majority (as opposed to unanimous) agreement. Although the court is involved in the application and approval of the scheme proposed, there is no need for the company to be insolvent. In the case of a securitization, this would involve the relevant classes of noteholders holding meetings and voting on the matters put to them.

Other insolvency proceedings?

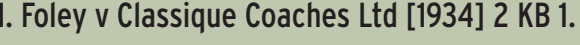
Another option, closely aligned but possibly more flexible than relying on specifically drafted events of default as described above, is to consider applying for, or persuading the issuer to file for, administration. Depending on the control rights granted in the transaction documents, the senior trancheholders may be able to take the lead on negotiating a pre-pack[9] deal with the administrator and the SPV issuer. The recent case of In re Zais Investment Grade Limited VII,[10] although a U.S. Chapter 11 process, is instructive of such an approach for English law structured finance transactions.

For noteholders that drive restructurings such as those mentioned above, there are other legal and regulatory matters to be mindful of. The detail of these issues goes beyond the purpose of this article, but suffice it to say that, invariably where a noteholder drives a restructuring of a structured finance transaction, it will need to seek specialist tax and regulatory advice (to address matters such as risk retention and market abuse).

Conclusion

In the end, there will be no substitute for carefully analyzing the facts and the transaction documents so as to understand how the provisions can be called on to assist in achieving the desired result. It will also be advisable to prepare for possible litigation on "grey" areas by seeking appropriate specialist advice. And players in this market will do well to bear in mind the backdrop of insolvency related tools available both to yourself and to your opponent. Understanding which tools will assist in capitalising on your position will be imperative to ensuring you achieve a happy restructuring outcome. ❑

THE FIRST STEP IS TO SCOUR THE CONTRACTUAL DOCUMENTATION FOR PROVISIONS THAT MIGHT ASSIST IN COMPELLING CONSENT



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1. Foley v Classique Coaches Ltd [1934] 2 KB 1.
2. The right of noteholders to agree upon amendments to their notes is subject to the principle that such amendments must be in the best interests of the class of noteholders affected: Assenagon Asset Management SA v Irish Bank Resolution Corporation Ltd [2012] EWHC 2090 (Ch).
3. The trustee may exercise its discretion to require that an indemnity be provided to it by the instructing parties before taking such action.
4. A-G of Belize v Belize Telecom [2009] 1 WLR 1988
5. Section 123(2) Insolvency Act 1986 provides the full statement of the "balance sheet" test: "A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."
6. BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc [2013] 1 WLR.
7. In the matter of ARM Asset Backed Securities A.S. [2013] EWHC 3351 (Ch).
8. The "fulcrum" point is where the "value breaks" in a capital structure. Those parties who own securities above the fulcrum (being those who are "in the money") will be entitled to vote in a Scheme of Arrangement; those who own securities below the fulcrum (being those who are "out of the money") will not be entitled to vote: Bluebrook Ltd and others [2009] EWHC 2114 (Ch) (the 'IMO Car Wash' decision).
9. A pre-packaged deal in the context of a securitization would involve the issuer SPV selling its assets to a newly formed SPVwhich will be burdened only with the debt of those at and above the fulcrum securities of the old insolvent SPV that filed for administration. Those holding securities below the fulcrum of the insolvent SPV will have their notes left behind at the old SPV(which will now be without assets). This could be facilitated by a scheme of arrangement amongst the relevant classes of noteholder in conjunction with the administration.
10. No.11-20243 (Bankr. D.N.J. Dec 21, 2011)

LSTA's Revised Trading Documents Allow Revolver Loan Investors to Protect Their Posted Collateral — But Only If They Ask

LSTA's Revised Trading Documents Allow Revolver Loan Investors to Protect Their Posted Collateral — But Only If They Ask

LAWRENCE V. GELBER, DAVID J. KARP, AND ERIK SCHNEIDER

The authors review changes made by the Loan Syndications and Trading Association to its Collateral Annex for Loan Participations and LSTA Par and Distressed Trade Confirmations.

On June 28, 2013, the Loan Syndications and Trading Association ("LSTA") announced that the revised Collateral Annex for Loan Participations and revised LSTA Par and Distressed Trade Confirmations became effective. The revisions to the LSTA's suite of documents have improved the ability of investors in revolver loan participations to protect themselves against the lender of records' insolvency risk. Investors face this risk when they are required to post collateral with the lender of record to support their obligations to fund the borrower's future draws on the revolving loan under the participation agreement. The revisions to the LSTA's documents include, among several other changes:

- a check-the-box option that allows collateral to be segregated with the seller or a third-party custodian;

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Published by Matthew Bender & Company, Inc. in the July/August 2013 issue of *Pratt's Journal of Bankruptcy Law*. Copyright © 2013 Reed Elsevier Properties SA.

- a revised formula to calculate the amount of collateral required; and
- more frequent triggers for the seller to return any excess collateral.

These revisions make it even more important for investors in revolver loans to negotiate these points at the time of the trade. If investors later have to settle a revolver loan trade by participation instead of by assignment, they may lack the leverage to negotiate the appropriate protections for their collateral. In addition, buy-side funds that frequently invest in revolvers may want to consider negotiating account control agreements with third-party custodians and each of their most frequent sell-side counterparties, if they are concerned about their sellers' credit risk.

THE LSTA COLLATERAL ANNEX IN PRACTICE — BUYERS FACE ADDITIONAL CREDIT RISK DUE TO COMINGLING OF COLLATERAL

The LSTA Collateral Annex is generally used when a trade for a revolving loan or commitment settles by participation instead of by assignment because the borrower did not consent to the assignment. Borrowers often have the right to consent to assignments of their revolver loans, even if they do not have consent rights with respect to assignments of term loans. Historically, borrowers have been reluctant to consent to an assignment of a revolving facility to investment funds because they (justified or not) are concerned with an investment fund's ability to fund their draws as reliably as a banking or similar financial institution. When a trade settles as a participation, the revolver lender remains obligated to the borrower to fund any future draws; however, under the participation agreement, the buyer is required to pay its share of any of the borrower's future draws to the revolver lender. On account of that same concern, revolver lenders that participate a piece of their revolver loans to an investment fund have typically required investment funds to post collateral with the revolver lender to secure their funding obligation under the participation agreement.

The LSTA's prior version of the Collateral Annex provided that the buyer would post its collateral into a comingled account with the seller and permit-

ted the seller to freely transfer, assign, invest, commingle, hypothecate, pledge or otherwise dispose of the buyer's collateral. As a result, if the seller were to become subject to a bankruptcy case or other insolvency proceeding (e.g., under SIPA or as part of an FDIC receivership), the buyer would not have any security interest or any other property right in the specific collateral it posted with the seller, even though the collateral was the buyer's property (unless and until the buyer defaults on its obligations). Effectively, the buyer's posted collateral would have dissipated into the seller's bankruptcy or receivership estate, and the buyer would only have an unsecured claim for the posted collateral against the seller's estate. Adding insult to injury, if there was a draw after the seller's insolvency, the buyer would remain obligated to fund the full amount — irrespective of the collateral it had posted.

LSTA'S REVISED COLLATERAL ANNEX

The LSTA's prior version of the Collateral Annex was published in 2008 and was due for an update in light of the Lehman Brothers and MF Global bankruptcies and increasing global regulatory focus on collateralization of derivative transactions, which has resulted in a number of new initiatives, including Dodd-Frank's provisions requiring collateral segregation (in the case of bilateral, unsecured swaps) and increased margin requirements. After close to a year of negotiations in the LSTA's Trade Practices and Forms Committee, the revised Collateral Annex, Par Trade Confirmation and Distressed Trade Confirmation include the following changes:

- Trade Confirmations
  - Includes: (i) a check-the-box option for segregation of collateral if the collateral account is established with the seller; and (ii) a further option to establish the collateral account with a third-party custodian.
    - Note that if neither of these options is *agreed to at the time of trade*, the default is for the collateral to be posted with the seller in a comingled account.
- Collateral Annex

- Allows for segregation of collateral with the seller, or with a third-party custodian (depending on what was agreed to in the trade confirmation).
- Two alternative formulas to calculate any collateral shortfall or collateral excess:
  - Option one is based on a percentage of the amount of unfunded commitments; and
  - Option two differs from option one by also taking into account the market value of the participation (subject to a haircut).
- Increased frequency of refunding excess collateral — changed from quarterly upon buyer's demand, to monthly, after revolver pay-downs and after draws, subject to the buyer and the seller negotiating the exact timing of payments.
- If the seller maintains the collateral account, it must provide monthly statements.

THE LSTA COLLATERAL ANNEX IN FUTURE PRACTICE

With these revisions, the LSTA has taken steps in bringing its suite of documents up to date given the current regulatory environment and credit-risk-conscious market. However, far from defaulting to options protecting buyers' rights in its collateral, the LSTA's revised Collateral Annex and the related check-the-box options in the trade confirmations merely give buyers the option to negotiate these terms with their seller. As a result, it is now even more important for buyers to educate their trading and operation personnel on these options so that these can be dealt with upfront at the time of trade. Neglecting to negotiate these points early in the life of a trade may result in sellers refusing to entertain any discussions of collateral segregation when these issues become pertinent.

Additionally, the LSTA's revised Par and Distressed Trade Confirmations contain a cautionary footnote that effectively discourages parties from opting for establishing a segregated collateral account with a third-party custodian if there is no agreed-upon control agreement in place. This footnote's language

arguably allows sellers to refuse to agree to any third-party custody arrangement until they have agreed to a control agreement. As a result, prudent buyers that are concerned about minimizing their exposure to counterparty credit risk under the LSTA's Collateral Annex should take immediate steps to negotiate a control agreement and be better positioned to segregate collateral with a third-party custodian for their revolver trades, if they so choose.

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The Co-operative Bank PLC Restructuring

Schulte Roth & Zabel

Alert

The Co-operative Bank PLC Restructuring

28 June 2013

The Bank's Restructuring Proposal

The Co-operative Bank PLC's (the "Bank") announcement last week of a proposed Exchange Offer (the "Exchange") of its subordinated bonds was presented almost as a *fait accomplis*. The fact is, of course, that the announcement can be no more than a proposal requiring consent of the requisite percentage of the bondholders themselves in accordance with the terms and conditions of the affected instruments. As there are different instruments contemplated to be affected by the Exchange, it will be interesting to see whether or not the Exchange will be presented as a "package deal" requiring the relevant majority consent of each instrument before the Exchange is considered accepted, thereby upping the stakes for all parties. The announcement clearly indicates that each instrument will have its own tailor-made Exchange of a mix of fixed-income instruments in the Co-operative Group Ltd and/or the Bank and shares in the Bank. There has further been no suggestion that the Exchange is going to be "coercive." Following the High Court's decision last year in *Assenagon v. IBRC*, any coercion would be highly controversial, signalling the Bank's preparedness to litigate all the way to the UK Supreme Court.

Bondholders Should Organise and Proactively Engage with the Bank and the Government

Many questions arise out of the announcement. What *practical* options do bondholders actually have to avoid the Exchange's threat of a significant haircut and partial exchange of their debt for equity in the Bank? The answer lies in organisation and engagement with their counter-party. It is clear in the terms and manner of the announcement that it is no more than an invitation from the Bank (and the Government) for the bondholders to negotiate a consensual deal. Bondholders should use the time between now and the announcement of the precise terms to engage in talks with the Bank to influence a fair arrangement amongst all stakeholders and other parties for contribution to the Bank's reported £1.5bn Common Equity Tier 1 capital shortfall (the "Tier 1 gap"). One obvious question that arises out of the announcement is whether the proposal could be said to be just and equitable in view of the fact that the existing shareholders of the Bank appear not to be contributing their fair share of the burden. Bondholders should further also be engaging in discussions with the Government to point out concerns as to the proper application to the Bank of the Governmental Authorities' (the "Authorities") powers under the Banking Act 2009 (the "2009 Act"), as further discussed below.

Alternatives to an Exchange

In preparing for the negotiations, bondholders should bear in mind the alternatives to the Exchange. Knowing the options available to the Bank and to the Authorities — and the downsides to those parties of invoking those options, as well as the limitations and scope of those options — are vital tools in the negotiations. The precise terms of the Exchange have not yet been announced, leaving bondholders to fear the worst. The stated date of October 2013 also gives plenty of time for the Bank and the Authorities to drum up press scare-mongering, so that bondholders will believe the worst. Being prepared is the best way to offset any fears.

One alternative to the Exchange that the Bank will be keen to remind bondholders of is that, absent the Exchange, the Bank may be seen as being in a degree of "financial difficulty" justifying the intervention of the

Authorities under the "Special Resolution Powers" of the 2009 Act. It is significant for bondholders that intervention may occur even before the onset of insolvency. In such a case, bondholders may nevertheless be looking to a recovery analysis on their investment, relying on an "independent valuer" appointed by the Authorities in assessing the value of their claim. Bondholders should be crunching the numbers on the likelihood of that scenario arising and they should be arming themselves now with grounds for judicial review. The Special Resolution Powers that bondholders will be fearing are those that (at least indirectly) adversely affect the value of the bonds. Whilst the controversial "bail in" powers may not be expressly permitted under the 2009 Act, the Authorities can certainly nationalise the bonds (for "adequate compensation") and also effect a transfer of the Bank's valuable assets, leaving the bondholders with a claim in a toxic or worthless vehicle — the classic 'good bank'/'bad bank' scenario.

Ammunition in the Bondholders' Armoury

There are, of course, strict criteria that the Authorities must satisfy before exercising their powers, and it is these criteria and the manner of exercise of the power that bondholders will carefully scrutinise in any judicial review process. The criteria that the Authorities must assess include:

- Concluding that there are no other viable ways of plugging the Tier 1 gap;
- Arriving at the decision that the action is 'necessary';
- Ensuring the accuracy of the Tier 1 gap calculation; and
- Ensuring the fairness and accuracy of any valuation exercise. (In any valuation argument, the Bank has the upper hand since bondholders will largely be at the mercy of information provided to it by the Bank.)

The Future of the Legislative Landscape

Bondholders should be aware of the wider EU Framework for Recovery and Resolution of Credit Institutions and Investment Firms Directive which is due to become an EU Directive at least by year-end. Whilst the UK Government will not need to rely on the powers under the Directive in order to legislate for a bondholder bail in in the Bank, the UK Government will no doubt be mindful of the marked shift in attitude across the EU and this is evidenced in the Financial Services (Banking Reform) Bill, which is due to be enacted shortly (though will be unlikely to apply retrospectively). Having said that, there is no guarantee that the UK Government will not pass legislation bespoke for the Bank's situation that includes a bail in. One thing is for certain — no longer will taxpayers be seen as the first port of call in bearing the burden of propping up a troubled bank. From now on, the shareholders, subordinated creditors and even senior creditors and depositors will be expected to bear that burden first, as seen very starkly in the recent bail in of depositors in the Cyprus banks.

Authored by Peter J.M. Declercq and Sonya Van de Graaff.

SRZ has significant experience in financial institution restructurings (including representing stakeholders of Northern Rock, the Irish Banks and Depfa Bank). If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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Advanced Distressed Debt Lesson: Bank Debt Trading on the Modern Day Back of the Napkin

Distressed Debt Investing

This blog will try to dissect distressed debt investing, up and down the capital structure. We will look at current distressed debt situations, try to explain the ins and outs of how decisions are made in the distressed debt world, probably rant a few times about positions that are working against me, and hopefully enlighten some readers.

LABELS

- 2009 distressed debt (3)
- 2010 distressed debt review (1)
- 2011 distressed debt market (1)
- 2011 distressed debt outlook (1)
- abitibibowater (2)
- acas (1)
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- cds auctions (1)
- CEDC (1)
- chrysler (2)

5.13.2013

Advanced Distressed Debt Lesson: Bank Debt Trading

Over the past few months, David Karp, partner at Schulte Roth & Zabel has enlightened readers with a fascinating series on the technicalities inherent in trading and closing trades in the world of distressed debt. For the last piece of the series, David takes on the complexities of bank debt trading, which has become an increasingly prevalent instrument for distressed debt funds to engage in. It's an incredible read. Enjoy!

Bank Debt Trading on the Modern Day Back of the Napkin

While it may be surprising to market outsiders, every day bank debt traders in the Unites States, Europe and around the world enter into multimillion dollar binding trades — over the phone, on Bloomberg instant messages and via email — for which many complex collateral, tax, counterparty risk and other material terms and conditions are left off of the modern day "back of napkin." While the Loan Syndication and Trading Association ("LSTA") and the Loan Market Association ("LMA") have set the baseline standards for bank debt trades in the United States and Europe respectively, trades often include material issues that need to be addressed after the traders say "done," but before entry into a formal written confirmation and eventual settlement. While recent case law in the United States and Europe has confirmed that these informal communications are binding, it also shows traders the importance of at least including some reference to material issues (in addition to price, amount and facility) on the "napkin" at time of trade.

For instance, the U.S. Court of Appeals for the Fifth Circuit held on Oct. 2, 2012 that an oral trade of certain bank debt from Bank of America ("BofA") to Highland Capital Management ("Highland") was binding despite follow-up emails stating that the claim was "subject to appropriate consents and documentation." *Highland Capital Mgmt., L.P. v. Bank of America, N.A.*, 698 F.3d 202 (5th Cir. 2012). That decision brings U.S. case law in line with a 2007 English High Court decision, which held that oral trades are binding even if certain terms of the trade, such as the settlement date or the form of transfer, remain undecided. See *Bear Stearns Bank plc v Forum Global Equity Ltd.* [2007] EWCH 1576. While the bank debt market's mantra continues to be "a trade is a trade" and the LSTA's standard documentation makes clear the binding nature of oral trades, what is interesting (and perhaps scary) about these cases is that they were resolved only through years of protracted litigation, involving a significant commitment of time and expense by the parties. Even if all of your counterparties have a full appreciation of the market standard that an oral trade is binding, judges are not in the market and, if the economic incentives are tempting enough, a counterparty could try to take advantage of courts' general lack of market awareness.

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In 2009, Highland and BofA began negotiations on a potential sale of certain bank debt of Regency Hospital from BofA to Highland. (*Footnote #1*) On Dec. 3, 2009, a representative from Highland called BofA to finalize the trade and its terms. *Id.* The parties agreed over the phone that Highland would purchase, and BofA would sell, $15.5 million of the debt at 93.5 percent of par and that the agreement incorporated the Standard Terms and Conditions published by the LSTA. *Id.* The BofA representative did not reserve any non-LSTA or non-industry terms during the Dec. 3, 2009 call. *Id.* After the call, the Highland representative sent an email to the BofA representative confirming that the debt-trade agreement was complete. *Id.* The BofA representative responded with a confirmation of the agreement, noting that it was "subject to appropriate consents and documentation." *Id.*

After the Dec. 3, 2009 call, BofA refused to settle the trade unless Highland agreed to additional terms, including an indemnification, payment of legal fees and waiver of legal claims. *Id. at 205*. Highland viewed these additional terms as departing from the standard LSTA terms and the Dec. 3, 2009 oral agreement. *Id.* The Regency Hospital loan ended up paying out 100 percent of par and Highland subsequently sued BofA for breach of contract. *Id.*

Relying on BofA's "subject to" language, the trial court held that the parties did not intend to be bound by the trade without additional "consents and documentation" and, therefore, granted BofA's motion to dismiss. *Highland Capital Mgmt., L.P. v. Bank of America, N.A.*, 2011 WL 5428779, at *5 (N.D. Tex. 2011). Highland appealed that decision to the Fifth Circuit arguing that the lower court failed to accept Highland's pleaded facts as true, as required on a motion to dismiss (as explained in note 1) and improperly considered factual issues related to the parties' intent and industry standards. *Highland*, 698 F.3d at 205.

Fifth Circuit's Analysis

The Fifth Circuit began by observing that oral contracts are valid under New York law. *Id.* at 206. In fact, New York law specifies that bank debt oral trades are binding under a statute providing that the statute of frauds does not apply to the assignment, sale, trade, participation or exchange of indebtedness or claims relating thereto under certain qualified financial contracts, which include bank debt. See N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii). However, if the parties do not intend to be bound until the oral contract is reduced to writing and signed, then the oral contract is not binding until that time. *Highland*, 698 F.3d at 206. Whether or not the parties intend to be bound is a factual issue to be determined by the court or a jury based on evidence. See *id.* The trial court nevertheless found BofA's intent not to be bound in its "subject to appropriate consents and documentation" email. *Id.*

Highland's complaint, however, alleged that the parties had agreed to all of the material terms on the Dec. 3, 2009 call because the LSTA standard terms specify that parties agree to be legally bound by any subsequent calls or emails that reach agreement on material terms. *Id.* at 207. Under Section 21 of the LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations, once you execute an LSTA trade confirmation, you are bound by the LSTA standard terms in all future debt trades with that same counterparty unless you specifically say otherwise at the time of trade. Section 21 LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations provides as follows:

> *By execution of a Confirmation incorporating by reference the Standard Terms and Conditions, each Buyer and Seller agrees to be legally bound to any other transaction between them ... with respect to the assignment, purchase, sale and/or participation of commercial and/or bank par/near par loans, or any interest therein, upon reaching agreement to the terms thereof (whether by telephone, exchange of electronic messages or otherwise, directly or through their respective agents, and whether the subject of a confirmation), subject to all the other terms and conditions set forth in any confirmation relating to such transaction, or otherwise agreed.*

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This also applies to distressed trades pursuant to Section 22 of the LSTA Standard Terms and Conditions for Distressed Trade Confirmations. The same section also commits the parties to New York law, and to not raise a defense for lack of a writing based on the statute of frauds.

Highland's complaint also correctly asserted that the "consents" referred to in BofA's "subject to" email referred to borrower consent, which is often required to effect the assignment of bank debt transfers. Id. Highland explained that, even if borrower consent were not available, the LSTA standard term would still require the parties to close the transaction by participation or otherwise. (The LMA standard terms include a similar provision. The potential pitfalls related to borrower consent in Europe are discussed in a prior post, Prospecting for European Distressed Loans.) Id. Highland's complaint also alleged that the "documentation" in BofA's "subject to" email referred to the execution of a standard LSTA trade confirmation, noting that the execution of the trade confirmation is not a condition precedent to formation of a binding trade. *Id.* at 207-08.

In its consideration of whether or not the parties intended to be bound by the oral agreement, the Fifth Circuit used the four-factor test generally used by courts in breach-of-oral-contract cases. *Id.* at 206. The test considers: "(1) whether there has been an express reservation of the right not to be bound in the absence of a writing; (2) whether there has been partial performance of the contract; (3) whether all of the terms of the alleged contract have been agreed upon; and (4) whether the agreement at issue is the type of contract usually committed to writing." Id. at 209. First, taking Highland's allegations as true, the Fifth Circuit saw no indication that BofA had expressly reserved the right not to be bound without a written agreement. *Id.* Second, Highland alleged that the parties had agreed on all material terms. *Id.* Finally, the LSTA standard terms indicate that debt trades can be conducted orally and only later committed to writing in a trade confirmation. *Id.* Taken all together, the Fifth Circuit concluded that the emails following the Dec. 3, 2009 phone call did not unambiguously indicate that the parties did not intend to be bound and, therefore, the issue of the parties' intent was unfit for a motion to dismiss at that early stage. See id. Given that the emails did not clearly negate an intention to be bound, without further evidence, the Fifth Circuit held that the district court erred in granting BofA's motion to dismiss. *Id.* at 210.

Accord with English Case Law

The Fifth Circuit's decision in *Highland* brings U.S. case law in line with English case law on the subject. In a 2007 opinion, the High Court held that parties to a notes trade were bound after they agreed on price over the phone, despite other outstanding terms of the trade, such as the settlement date. See *Bear Stearns Bank plc v Forum Global Equity Ltd.* [2007] EWCH 1576. In the *Bear Stearns* case, the High Court considered the binding effect of a phone call agreeing to the price of Parmalat SpA notes and accompanying claims in the Parmalat insolvency under the Marzano Law Decree. Much like the analysis performed by U.S. courts, the High Court considered the parties' intent to be bound and held that the buyer did show such an intent when it orally provided a "firm bid" on the price. The court held that there was a binding oral agreement, even though there was no agreement on a settlement date or the form of transfer, because there was no legal reason why the parties could not later reduce the agreement to a writing in which the buyer obtained the economic benefit of the notes and claims in exchange for the agreed price. Unlike in the *Highland* case, however, the High Court did not conclude that the standard terms of the LMA, the English equivalent of the LSTA, applied because the parties did not specifically refer to LMA standard terms at the time of the call and there was no clear and convincing evidence that at the time of the trade (July 2005) it was an established practice to use LMA terms for transactions in this type of asset, given the unusual nature of the particular claims that accompanied the notes. Nevertheless, there is now clear case law in both the U.S. and England that upholds the binding nature of oral debt trades.

Practical Considerations

The trial court decision in *Highland* was completely at odds with market understanding and it took a successful appeal to the Fifth Circuit to bring the decision in line with market expectations. The time from trade to appellate decision (solely on the motion to dismiss) was almost three years. This is not the first time (and will not be the last) that parties have

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had to "take one for the team" and litigate an issue — one that perhaps the market had taken for granted — up to the circuit court level in order to get case law up to speed. For example, as discussed in Part I of this series, we saw Longacre fight the good fight in the Second Circuit to confirm that "objected to" means "objected to," with respect to claim assignment put right triggers where a claim seller attempted to add a "substantive" objection requirement to the plain language of the claims trade contract.

The trial court in the Northern District of Texas missed the mark in *Highland*. There are plenty of other district and state courts that are not bound by the Fifth Circuit's *Highland* decision that could do the same. In fact, we need only look to the New York Appellate Division, First Department's decision in *Credit Suisse First Boston v. Utrecht-America Finance Co.*, 80 A.D.3d 485 (N.Y. App. Div., 1st Dep't 2011), which suggested that a trade confirmation that included language that the trade was "subject to negotiation, execution and delivery of reasonably acceptable contracts and instruments of transfer," which is in all standard LSTA trade confirmations, imposed on the parties only an obligation to negotiate the definitive documents in good faith, not a binding obligation to close the transaction. See id. at 19-20. While that case settled after the Appellate Division remanded it to the trial court for determination of certain factual issues, the mere suggestion (by a New York court, no less) that a standard LSTA trade confirmation was not a binding agreement to close the transaction has certainly caused some jitters for traders and their counsel.

The take-away is to front load as many of your desired terms (amount, price, tranche, form of transfer, participation or assignment only, interest convention, etc.) into the initial trade conversation as possible so that there are no surprises in the written trade confirmation process.

Footnote #1: Procedurally, on an appeal of a motion to dismiss, the appellate court only considers the facts as presented in the appellant's briefs and assumes those facts to be true, without taking the evidence or testimony that would be presented in a trial setting. Therefore, the facts presented in this piece, as taken from the Fifth Circuit's opinion, are Highland's version of the facts, and the Fifth Circuit made clear that it was not taking a position on the veracity of those facts but only considering the parties' purely legal arguments. Id. at 204.

David J. Karp is a partner 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 & Claims Trading Group, which provides advice in connection with U.S., European and emerging market credit trading matters. David is an avid speaker and writer on distressed investing related issues, recently co-authoring "European Insolvency Claims Trading: Is Iceland the Paradigm?" for Butterworths Journal of International Banking and Financial Law and "Trade Risk in European Secondary Loans" for The Hedge Fund Law Report. David is an active member of the LMA, APLMA, INSOL Europe and the LSTA where he is a member of the Trade Practices and Forms Committee. Alexia Petrou and Neil Begley, associates at SRZ, assisted in the preparation of this entry.

Posted by Hunter

1 COMMENTS:

Anonymous, 5/14/2013

Hunter, you're sharing all these things for free for so long, awesome. Thank you.

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ABOUT ME

I have spent the majority of my career as a value investor. For the past 8 years, I have worked on the buy side as a distressed debt and high yield investor.

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Advanced Distressed Debt Trading & Trade Dispute Litigation: Debtor vs. Secondary Market Claims Purchaser

Distressed Debt Investing

This blog will try to dissect distressed debt investing, up and down the capital structure. We will look at current distressed debt situations, try to explain the ins and outs of how decisions are made in the distressed debt world, probably rant a few times about positions that are working against me, and hopefully enlighten some readers.

1.23.2013

Advanced Distressed Debt Lesson: Trade Dispute Litigation

For the past few months, David Karp, partner at Schulte Roth & Zabel, has contributed a number of fascinating articles on issues pertinent to trading in distressed debt, both domestically and overseas. I have gotten to know David over the past few months and he undoubtedly is one of the best in the field at what he does best: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims.

He's back with another fantastic, and timely, post. This one concerning a very recent decision related to claims trading in an oldie, but a goodie: the KB Toys bankruptcy and ASM Capital (defined below as Purchaser). This is a long one, but funds and desks transacting in claims will learn a great deal from the post. Enjoy!

Advanced Distressed Debt Trading & Trade Dispute Litigation: Debtor vs. Secondary Market Claims Purchaser

Our last post, Advanced Distressed Debt Lesson: Trade Dispute Litigation: What Distressed Investors Need to Know, focused on a claim buyer's rights against a claims seller in the event that the specific claim sold is or becomes impaired. This post discusses the risk of impairment in the context of a dispute between the debtor's liquidating trustee and a claims purchaser. On Jan. 4, 2013, the U.S. District Court for the District of Delaware upheld a bankruptcy court ruling that a so-called "section 502(d)" claim impairment travels with a claim in a typical claims trading transaction, rather than staying with the seller as a "personal disability." *In re KB Toys Inc., et al.*, Civ. No. 12-716 (D. Del. entered Jan. 4, 2013). Regardless of this district court ruling on these highly debated issues, or the outcome of any potential appeal to the Third Circuit, traders and analysts should focus on the diligence pointers provided by this case, which demonstrate that this trip to court by the claims purchaser might have been avoided.

KB Toys, a mall-based toy retailer, filed for Chapter 11 protection in early 2004. Between the Chapter 11 petition date and confirmation of its plan of reorganization in the summer of 2005 (followed by a second Chapter 11 filing and liquidation in 2008), "Purchaser" acquired 34 trade vendor claims ranging in size from $792.00 to $2.6 million, for a total combined face amount of approximately $7.5 million.

When purchasing multiple claims to build a position, it is not uncommon for claims investors to utilize a "portfolio theory" approach to aggregating claims against one debtor and spreading the risk that an individual claim is or will become impaired across a bundle of small claims, with the expectation that actual losses on any "bad" individual claim would be exceeded by higher returns on the bundle. Appearing to use this strategy, the Purchaser acquired each of the 34 claims on a short-form assignment agreement consisting of one to two pages of basic representations, warranties and indemnities. That being said, the Purchaser's forms used for the KB Toys claim purchases, redacted copies of which were filed with the court, vary slightly between the different trades and are on a modified short-form recourse structure, meaning the risk of an impairment of a claim should remain with the claims seller through a put right and indemnification for breach of representations and warranties. For a more detailed discussion of recourse structures and claims trading risk allocation structures, see Claims Traders Beware: More Risk Than You Bargained For! Each of the nine purchase agreement forms for the disputed claims

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included a put right and four out of nine included indemnification for the seller's breach of representations and warranties, which included, among others, that the claim was valid in the amount specified and that no objections to the claim existed.

In late July 2009, after the Purchaser had settled more than 30 trades and accumulated more than $7 million in face value of claims, the KB Toys trustee filed an omnibus objection to certain claims based on section 502(d) of the Bankruptcy Code. Section 502(d) requires the court to "disallow any claim of any entity from which property is recoverable" under an avoidance action, such as a preference claim "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable." *See* 11 U.S.C. § 502(d). The Purchaser may have been surprised to see nine of its claims listed in that objection. The nine claims listed, the largest of which was for only $163,000, totaled about $672,000 or approximately 9.5 percent of the Purchaser's total position.

In many cases, one of the hallmarks of a portfolio strategy for claims purchasers is less claim and seller-specific diligence and lighter purchase documents in order to facilitate a quick trade and settlement. Light diligence aside, the Purchaser might have easily discovered, in advance of buying the claims, that many of the claims it was buying were subject to potential section 502(d) disallowance. As required of all Chapter 11 debtors, KB Toys had filed a Statement of Financial Affairs ("SOFA") that listed all payments to creditors of more than $600 in the 90 days immediately preceding the petition date. KB Toys's SOFA listed the nine claimants from which the Purchaser purchased the claims at issue, including the dates and amounts of the payments from KB Toys to the creditors. **While we will delve more deeply into avoidance action law below, certain payments from a debtor in the 90 days prior to its filing can be avoided by the trustee or debtor-in-possession.** Had the Purchaser reviewed KB Toys's SOFA, it would have been aware that those original sellers were potentially subject to preference actions by the trustee and, therefore, their claims were also potentially subject to disallowance under section 502(d). In addition, the original holder of the largest claim was already subject to a default judgment in the amount of $18,181 obtained by the trustee in advance of the Purchaser purchasing the claim. This fact was readily discoverable in a search of the debtor's case docket.

The public record is unclear on what, if any, efforts the Purchaser took to collect from the original claimholders under the assignment agreements' put-right or indemnification provisions. We can speculate that such efforts have not been successful to date, as the Purchaser has since gone to great lengths to challenge the trustee's objection to its nine claims since it was filed in July 2009 — arguing, among other things, that the trustee's section 502(d) defense does not travel with the claim to the transferee.

As is the case with most assignment of claims agreements, the Purchaser's assignments are governed by New York law. Unfortunately for market participants (and their counsel), but perhaps fortunate for the Purchaser, the state of New York law as to whether or not claim impairments are specific to the claim can be characterized as murky, at best. This is due to the oft-criticized decision known as *Enron II*. *Enron Corp. v. Springfield Assocs., LLC (In re Enron Corp.*), 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"). In the *Enron* case, the debtor sought to use section 502(d) to disallow claims held by secondary market transferees. As with the Purchaser's claims, one of the issues for the court to consider in *Enron* was the extent, if any, to which a claim subject to section 502(d) disallowance in the hands of the transferor remains subject to section 502(d) disallowance in the hands of a transferee that was not involved in the avoidable transfer that gave rise to the 502(d) defense. The bankruptcy court, in *Enron* I, held that, since the claims in the hands of the transferor would be subject to section 502(d), the transferees are subject to the same claim disallowance under section 502(d). *Enron Corp. v. Avenue Special Situation Funds II, LP (In re Enron Corp.*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006) ("*Enron I*").

In the appeal of the *Enron I* decision, *Enron II*, the district court considered "whether . . . disallowance under 502(d) can be applied, as a matter of law, to claims held by transferees to the same extent they would be applied to the claims if they were still held by the transferor based on alleged acts or omissions on the part of the transferor." *Enron II*, 379 B.R. at 427-28. In its opinion, the district court considered the legislative objectives of the statute and cited the "twin aims" of disallowance under section 502(d): to assure

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equality of distribution of the estate assets and to coerce compliance with judicial orders. *Id.* at 435. The district court then attempted to make a distinction between the effect of a "sale" versus an "assignment." The district court described an assignment as a transfer in which the assignee stands in the shoes of the assignor, taking the claim with whatever limitation it had in the hands of the assignor. *See id.* at 436. **In other words, in an assignment of a claim, all limitations and disabilities of the claim and the transferor travel with the claim to the transferee, whereas in a sale, some limitations and disabilities can travel with the claim, but personal disabilities of the claimant remain with the claimant**. *Id.* The district court looked at the language of 502(d) and determined that the emphasis on the entity suggested that 502(d) is a personal disability of the claimant that travels by assignment. *Id.* at 443. As to whether or not the Enron transfer was a sale or an assignment, the district court held that this determination required examination by the bankruptcy court of the "nature of the transfers." *Id.* at 445-46. However, before the bankruptcy court could make a determination of that issue, the parties settled the claims, leaving claims and distressed debt trading market participants scratching their heads and wondering what exactly makes a transfer an assignment versus a sale.

This leads us back to the Purchaser's purchases (or were they assignments?) of the KB Toys claims. Faced with the KB Toys trustee's objection to the nine claims on section 502(d) disallowance grounds, the Purchaser naturally responded by waving the *Enron II* flag. In response to the trustee's objections, the Purchaser argued to Judge Carey in the Delaware bankruptcy court that, based on *Enron II*, the claims at issue were transferred as "sales" and that the language of section 502(d) focuses on the claimant and, therefore, is a personal disability of the claimant that did not travel with the claim in the sale. *In re KB Toys, Inc.*, 470 B.R. 331, 335 (Bankr. D. Del. 2012). Conversely, the KB Toys trustee questioned the analysis of *Enron II* and the resulting policy concerns and argued that, even if accepting *Enron II*, the transfers to the Purchaser were assignments and that the Purchaser had at least constructive knowledge of the claims, making the Purchaser's purchases of the claims not in good faith. *Id.*

With analysis harkening back to the pre-1978 Bankruptcy Act (and even to case law from 1902), Judge Carey concluded that legislative history and case precedent support the notion that disabilities travel with the claim to the transferee. *Id.* at 335-37. Judge Carey echoed the analysis in *Enron I* and questioned the "sale versus assignment" distinction advanced in *Enron II*. *Id.* at 337-41. Judge Carey noted that the distinction has been highly criticized and observed that, "even if there exists a clean and principled way to distinguish between assignment and sale, the exercise, in this context, is unhelpful and unrevealing of the appropriate outcome." *Id.* at 341.

Judge Carey also rejected the *Enron II* policy assertion that burdening the transferee with the disabilities imposed on the claim would upset the trading markets as a "hobgobin [sic] without a house to haunt," because buyers of debt are highly sophisticated and fully capable of performing due diligence before any acquisition. *Id.* at 342. **Even without any due diligence, market players are fully aware of the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances.** *Id.* Judge Carey observed that the Purchaser could have discovered the potential for disallowance with very little due diligence and could have factored that into the price. *Id.* The fact that some of the assignment agreements had indemnification for disallowance evidenced the Purchaser's understanding of the possible risks and its leverage to appropriately protect itself. *Id.*

Judge Carey also rejected the Purchaser's argument that it should be protected from disallowance as a purchaser in good faith, reasoning that a purchaser of bankruptcy claims is well aware of the debtor's financial difficulties and is entering a market in which claims are allowed and disallowed in accordance with the Bankruptcy Code. *Id.* at 343. **In short, purchasers of bankruptcy claims are not entitled to the protections of a good faith purchaser.** *Id.* Judge Carey was careful to point out in a footnote, however, that the ruling only relates to trade claims purchased from an original holder and not to other types of transfers, such as publicly traded notes, etc. Id. at 342 n.14.

The Purchaser then appealed Judge Carey's ruling to the District Court for the District of Delaware and the appeal papers more or less rehashed the same issues and arguments as

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presented to the bankruptcy court. Oral argument on the appeal was held on Jan. 4, 2013 and Judge Richard G. Andrews upheld Judge Carey's ruling. According to the hearing transcript, Judge Andrews's view of the language of section 502(d) is that it could be read either way, but he nevertheless agreed with the rest of Judge Carey's analysis. Judge Andrews was particularly focused on the policy rationale that the Purchaser should bear the risk of a section 502(d) impairment because it is in a better position to protect itself, as opposed to other unnamed creditors whose claims would be diluted if transfers had the effect of cleansing claims of such impairments. Feeling that he would not have much to add on the matter, Judge Andrews refrained from issuing a written opinion but welcomed the Purchaser to seek appeal to the Third Circuit to perhaps move closer to a definitive resolution of this issue. We would like to be able to say this ruling, or the outcome of any potential appeal to the Third Circuit, provides clarity on the state of the law in this area, but a Delaware district court ruling, or even a Third Circuit decision on appeal, will not have the precedential force to change the fact that *Enron II* is still out there and, despite widespread criticism, is still the law in New York.

No matter the outcome, the KB Toys case is a good reminder to the market that disallowance under section 502(d) is a real risk. The sale/assignment, personal/non-personal disabilities distinctions are too vague and legally opaque to be relied on by purchasers of claims. There are many more practical and reliable techniques available for purchasers to protect themselves. First, through due diligence. Even when accumulating small trade claims, work with your attorneys to create a diligence checklist for each debtor you are considering, review the SOFA, the case docket, and do an Internet search on the seller to see if you **uncover any potential "insider" (as defined under the Bankruptcy Code) connections to the debtor, which could increase the preference period from 90 days to one year.** Second, protect yourself in the trade documents (which you should do in most cases, regardless of the due diligence outcomes). Make sure your documents have strong seller representations, including that the claim is not (and will not be) subject to "disallowance (including, without limitation, pursuant to section 502(d) of the Bankruptcy Code)," avoidance, subordination, or be otherwise impaired. Have a clear indemnification provision for breach of representations and claim impairments. Of course, document-based protections do come with the credit risk of the seller, which brings you back to due diligence.

What should you do if your due diligence does uncover potential section 502(d) issues? Run for the hills? Not necessarily. There are some circumstances in which claims could be attractive even with the potential for section 502(d) disallowance. The potential section 502(d) disallowance can be settled, whereby the amount paid to the seller is used to resolve the trustee's avoidance action in order to get the claim allowed. Or, the avoidance action could be priced into the trade or the seller might be willing to escrow the avoidance action claim amount until the claim objection is resolved. The bottom line is that even where a purchaser is quickly aggregating small claims through a "portfolio theory" approach, an upfront investment in pre-trade diligence and transaction structuring far outweighs the time, cost and expense required if a dispute arises and it finds itself in court.

David J. Karp is a partner in the New York and London offices of Schulte Roth & Zabel LLP, 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 & Claims Trading Group, which provides advice in connection with U.S., European and emerging market credit trading matters. David is a frequent speaker and writer on distressed investing related issues, recently co-authoring "European Insolvency Claims Trading: Is Iceland the Paradigm?" for Butterworths Journal of International Banking and Financial Law and "Trade Risk in European Secondary Loans" for The Hedge Fund Law Report. David is an active member of the LMA, APLMA, INSOL Europe and the LSTA where he is a member of the Trade Practices and Forms Committee. Neil Begley, an associates at SRZ, assisted in the preparation of this entry.

Advanced Distressed Debt Lesson: Trade Dispute Litigation: What Distressed Investors Need to Know

Distressed Debt Investing

This blog will try to dissect distressed debt investing, up and down the capital structure. We will look at current distressed debt situations, try to explain the ins and outs of how decisions are made in the distressed debt world, probably rant a few times about positions that are working against me, and hopefully enlighten some readers.

10.25.2012

Advanced Distressed Debt Lesson: Trade Dispute Litigation: What Distressed Investors Need to Know

A few months ago we introduced readers to one of Distressed Debt Investing's new contributors: David Karp of Schulte Roth Zabel. His first post was well received by our readers. Now David is back with a series of posts that I think are HIGHLY topical to the current investment environment, especially as more and more investors move into trading claims and bank debt to pick up added returns in less liquid parts of the capital structure.

A problem of course is that with trade claims, there comes a number of salient issues on the more technical aspects of the trade. Buying a registered bond that is represented by an indenture trustee in a bankruptcy brings about it some benefits due to market standardization and history. Conversely buying a trade claim carries unique risks specific to the claim. (A detailed primer on these risks and how the market trades around then can be found in the linked article David co-wrote for Bloomberg Law Report in January 2011) This year those risks have been brought to light due to a number of rulings and case dealing with trade dispute litigation.

A number of courts have recently considered common bank debt and bankruptcy claims trading terms and conditions under New York law, addressing one or more central issues for distressed debt traders and in some cases challenging investors' fundamental understanding of the effect of "market standard" transfer documentation. While some of the decisions have given the market comfort, others have left distressed investors scratching their heads.

David's next three posts will highlight the impact these cases may have on distressed debt traders and explain how certain of these disputes may have been preventable through better pre-trade diligence and planning.

Part I of this series highlights a dispute between a trade vendor and a bankruptcy claims buyer over when the buyer's put right, triggered by a potential impairment of the purchased claim, becomes enforceable and whether or not the buyer can rely on the seller's representations and warranties as forward looking guarantees as to the validity of the claim. Part II will analyze a dispute between a claims buyer and the Debtor's liquidating trustee over the trustee's objection to the purchased claim. Part III of this series will explain new 5th Circuit case law clarifying the binding nature of oral agreements for bank debt trades in a manner consistent with the courts of England and Wales confirming for both US and UK based distressed bank debt traders that "done" means "done" and even when trades are subject to documentation and consents.

Enjoy the post!

Part I: "Offensive" Use of Put Right by Bankruptcy Claims Buyer

A recent decision by the Second Circuit highlights a bankruptcy claim buyer's use of a contractual put right as an offensive weapon to offset an investment turned sour. The Second Circuit vacated a SDNY District Court decision that had denied the buyer's attempt to enforce its put right triggered by an objection against the claim.

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In that case, the buyer, Longacre Master Fund, Ltd. (Longacre), had purchased certain claims against Delphi Automotive Systems from ATS Automation Tooling Systems, Inc. (ATS). In a companion case, Longacre purchased similar Delphi claims from D & S Machine Products, Inc. (D&S). The claim purchase documents in both cases were "full recourse" documents that gave Longacre the right to require ATS or D&S to repurchase their claim, with interest, in the event it became "objected to."

At the time of the purchase, the distressed investors expected unsecured creditors to receive nearly a full recovery and Longacre paid ATS around 89 cents/dollar for the claims. Delphi's case did not turn out as most investors anticipated, and the unsecured creditors' recovery under the confirmed plan of reorganization was far lower than initially expected. After the plan went effective, Delphi's post-reorganization successor included the ATS claims in an omnibus objection under section 502(d) of the bankruptcy code. A 502(d) objection to a claim asserts that the claimant is subject to a preference action and until that action is resolved, the claims is temporarily disallowed. In this case, ATS had received certain payments from the debtor during the 90-day preference period, making it a potential preference defendant.

After ATS failed to resolve the objection to the claim with the 180-day grace period provided in the Assignment of Claim Agreement, Longacre demanded the refund of its purchase price plus interest. ATS rejected the demand and Longacre then sought to enforce the contract through litigation in the District Court for the Southern District of New York.

Longacre's suit principally relied on two contract provisions in the Assignment of Claim Agreement. First, it alleged, the omnibus objection constituted an "Impairment" under paragraph 7 of the Assignment of Claim Agreement: *"Subject to paragraph 16 below, in the event all or any part of the Claim is ... offset, objected to, disallowed, subordinated, in whole or in part, in the Case for any reason whatsoever, pursuant to an order of the Bankruptcy Court (whether or not such order is appealed) ... (collectively, an "Impairment"), Seller agrees to immediately repay, within 5 business days on demand of Buyers (which demand shall be made at Buyers' sole option), an amount equal to the portion of the Minimum Claim Amount subject to the Impairment multiplied by the Purchase Rate ..., plus interest thereon at 10 percent per annum from the date hereof to the date of repayment."* Focusing in, Paragraph 7 provides that a claim is impaired when "all or any part of the Claim is . . . objected to . . . for any reason whatsoever, pursuant to an order of the Bankruptcy Court."

Longacre also asserted that the debtor's omnibus objection constituted "Possible Impairment" not resolved within 180 days under Paragraph 16 of the Assignment of Claim Agreement: *"[I]n the event a possible Impairment is raised against the Claim in the Case and actually received by Buyers (a "Possible Impairment"), Buyers shall promptly notify Seller.... If at any time after the 180th calendar day following the day on which the Possible Impairment was filed against the Claim or otherwise formally commenced (herein, the "Limitation Day"), Seller's opposition and/or defense against the Possible Impairment has not been fully resolved and is not likely to be fully resolved within a reasonable period of time, then Seller must immediately repay an amount calculated in accordance with paragraph 7, as if there were an Impairment in respect of all or part of the Claim and Buyers had made a demand under paragraph 7.*

The District Court did not enforce these provisions as written, but rather granted ATS' motion for summary judgment. See [Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.](), 456 B.R. 633 (S.D.N.Y. 20122). The court disagreed with Longacre that the debtors' omnibus objection constituted an "Impairment" or even "Possible Impairment" because an objection based on section 502(d) is not a substantive objection to a claim. In so doing, Judge Sweet implied that the "objected to" language of the put right only referred to objections that challenged the validity or enforceability of the claim in the hands of the transferee. Analyzing the merits of the objection, the court found that the debtor's "objection" was actually just a reservation of its right to object to the claim in the future. The court's reasoning was partially based on a much-criticized decision in *Enron II*, which purported to distinguish rights and disabilities that travel with a claim based on whether the transfer was done by "sale" or an "assignment." This curious and much criticized line of reasoning has now come into play in the context of purchases of

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claims against KB Toys, Inc. There, after neither party could, in the bankruptcy court's view, adequately articulate the difference between a sale and an assignment, Judge Carey of the Bankruptcy Court in Delaware, rejected the *Enron II* holding. See *In re KB Toys et al.*, No. 04-10120, 2012 WL 1570755 (Bankr. D. Del. May 4, 2012). Judge Carey's decision is currently on appeal to the District Court of Delaware in *ASM Capital LP v. Residual Trustee of KBTI Trust (In re KB Toys, Inc.)*, No. 12-716 (D. Del.). *Enron II* and *In re KB Toys et al.* will be the subject of Part II of this series.

Contrary to the ATS decision, Longacre's prevailed in its case against D&S, also decided in the District Court of the Southern District of New York and on principally the same issues. See *Longacre Master Fund, Ltd. v. D & S Machine Products, Inc.*, No. 10-6090 (S.D.N.Y. Feb. 14, 2011). In the D&S case, Judge Pauley broadly interpreted "objection" and found that the put right was triggered by Delphi's filing of its objection. Given the divergent district court rulings, these cases were consolidated for purposes of appeal to the Second Circuit.

The parties' appeal papers painted very different pictures of the suits. D&S called Longacre's action to enforce the provisions as "nothing more than a disingenuous attempt to evade the consequences of its poor investment decision." Similarly, ATS called Longacre's efforts "desperate and disingenuous." Longacre's pleadings, on the other hand, stressed the "clear, unambiguous terms" of the agreements and that an objection is an objection.

The Second Circuit reversed Judge Sweet's ruling in the ATS case, holding that "nothing in the language of Paragraph 7 of the Assignment of Claim Agreement requires that the objection be meritorious" and Paragraph 16 requires the temporary return of the purchase price when there is an unresolved "Possible Impairment." The Second Circuit also held that the mere filing of the omnibus objection triggered ATS's repurchase obligation, "stating they were 'objecting to' the [Claims], and the Bankruptcy Court issued an order stating that the 'Objection' was preserved," regardless of whether the "objection" constituted a reservation of rights. The Second Circuit did, however, remand the case to determine the factual question of whether ATS had knowledge, at the time of the assignment, of a potential impairment of the claim related to a preference payment, which would result in a breach of ATS's representation that "to the best of ATS's knowledge, the Claim is not subject to any defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action."

In its complaints against ATS and D&S, Longacre also claimed that the actions filed against the original claimholders and the objections by Delphi also caused the sellers to breach their representations and warranties in the Assignment of Claim Agreements. For example, Longacre claimed that the Delphi objection breached ATS's representations that "the Claim is a valid Claim in the amount of at least $2,138,334.67." Critically for market participants, enforceability of this type of representation as a forward looking guarantee remains unresolved as neither district court was willing to find, at the summary judgment stage, that the contract unambiguously required representations and warranties to be satisfied after the Effective Date. Judge Sweet, *in ATS*, explicitly stated that the contract called for the truthfulness of the representations and warranties to be evaluated on the Effective Date because these were not expressly forward-looking. In D&S, Judge Pauley held that a representation that the claim "will not be disputed or defended [] is arguably contrary to the reasonable expectation of the parties because it would require D&S to make warranties and representations regarding matters over which it has no control." This interpretation that the representations and warranties are not in certain cases forward-looking, even though they did not relate to a specific time, is generally inconsistent with claims buyers' expectations . Unfortunately, these cases will not yield further clarity on the forward-looking nature of reps and warranties because that issue was not the subject of the Second Circuit appeal.

Takeaways

Claims buyers should find comfort in the fact that the Second Circuit's holding enforced the express language of the Assignment of Claim Agreement in a manner consistent with market expectations of the function and triggers for contractual put rights. Courts, however, may be sympathetic to claims seller's (especially non-market participants)

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arguments against claims buyers attempts to use a put right or indemnification offensively, to recover from a bad investment, as opposed to defensively to protect against a specific "impaired" claim. Even though Longacre appears to have overestimated the recovery on the Delphi claims, it was able to mitigate and possibly eliminate its loss through offensive use of its contractual put right. If Longacre prevails on remand in the District Court, it will recover interest on the purchase amount from the trade date until the date the objection was ultimately resolved, which may result in turning its likely loss into a winning trade.

David J. Karp is a Partner in the New York and London offices of Schulte Roth & Zabel LLP, 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 & Claims Trading Group, which provides advice in connection with U.S., European and emerging market credit trading matters. David is an avid speaker and writer on distressed investing related issues, recently co-authoring "European Insolvency Claims Trading: Is Iceland the Paradigm?" for Butterworths Journal of International Banking and Financial Law and "Trade Risk in European Secondary Loans" for The Hedge Fund Law Report. David is an active member of the LMA, APLMA, INSOL Europe and the LSTA where he is a member of the Trade Practices and Forms Committee. Erik Schneider and Neil Begley, associates at SRZ, assisted in the preparation of this entry.

English High Court Clarifies Post–Settlement Treatment of Interest and Fees for Secondary Market Participants

Schulte Roth&Zabel

Alert

English High Court Clarifies Post-Settlement Treatment of Interest and Fees for Secondary Market Participants

14 September 2012

A recent High Court decision demonstrates one occasion where a secondary market buyer of bank debt may be required to pay its seller monies under a credit agreement after a settlement date has passed. This decision is important for European distressed debt market participants trading on Loan Market Association ("LMA") documents, as it clarifies that a buyer's payment obligations to a seller may continue after a transaction has closed, and it further highlights that pre-trade diligence should include a clear understanding of how and when interest, fees or any other repaid cash is allocated.

Background

Tael One Partners Ltd. (acting in its capacity as general partner of The Asian Entrepreneur Legacy One LP) ("Seller") was an original lender of US$32 million under a 24-month, US$100 million syndicated credit agreement dated 16 April 2009 (as amended and restated on 26 Nov. 2009). The agreement provided for the borrower to pay interest at a rate of 11.25 percent p/a, accruing daily but payable three months in arrears, and a "Payment Premium" to be made alongside the repayment of the principal amount of the loan, varying between 17-20 percent depending on the circumstances surrounding the repayment.

On 14 Jan. 2010, the Seller transferred US$11 million of its debt position to Morgan Stanley & Co. International PLC ("Buyer"). The trade was conducted on the basis of the LMA standard terms and conditions for par trade transactions ("ST&C").[1] A pricing letter was executed with a schedule setting out amounts payable by the Buyer, including interest. The elected form of interest treatment was "Paid on Settlement Date," and there was also no reference to the Payment Premium mentioned. The Buyer subsequently sold its position onwards to a third-party.

On 16 Dec. 2010, the borrower repaid the loan in full and paid the Payment Premium to all lenders of record. The Seller subsequently contacted the Buyer requesting the Seller to pay it the proportion of the Payment Premium relating to the US$11 million traded debt which had accrued as of 14 Jan. 2010. This request was disputed by the Buyer.

[1] Effective 25 Jan. 2010, the LMA modified its documentation so that only one set of terms and conditions govern both "par" and "distressed" trade transactions. As this trade occurred prior to the modified documentation going live, the conditions referenced in this *Alert* are based on the old terms and conditions which are no longer in force. However, it should be noted that the LMA language set out in this *Alert* has not changed in form following such modification.

Analysis
The High Court focused on the agreed terms of trade between the Buyer and the Seller, which included interest being calculated on a Paid on Settlement Date basis. The relevant LMA ST&Cs documenting this form of interest treatment are Condition 11.3 and Condition 11.9:

- Condition 11.3(a) states that "*the Buyer shall pay to the Seller on the Settlement Date … any interest or fees accrued up to but excluding the Settlement Date in respect of the Purchased Assets (other than (i) PIK Interest and (ii) the fees referred to in paragraph (b) of condition 11.9 … which are payable after the Trade Date*."

- Condition 11.9(a) states that "*any interest or fees … which are payable under the Credit Agreement in respect of the Purchased Assets and which are expressed to accrue by reference to the lapse of time shall, to the extent that they accrue in respect of the period before (and not including) the Settlement Date, be for the account of the Seller and, to the extent they accrue in respect of the period after (and including) the Settlement Date, be for the account of the Buyer*."

The Buyer argued that the Seller was not entitled to a proportion of the Payment Premium because the Payment Premium did not "accrue" either up to the settlement date (Condition 11.3(a)) or in respect of the period before the settlement date (Condition 11.9(a)). Counsel for the Buyer further argued that Conditions 11.3(a) and 11.9(a) should be read together and that Condition 11.9(a) simply defined what is capable of falling within Condition 11.3(a), helping parties identify what is to be paid on the settlement date of a bank debt transaction. The Buyer's argument was based on the assumption that a secondary bank debt transaction is meant to be concluded by payment of the settlement amount on the settlement date, supporting the "clean break" of a transaction between old lender and new lender under a credit agreement.

The court did not accept the Buyer's arguments, instead providing a distinction in the explicit wording under both Conditions 11.3(a) and 11.9(a), which resulted in a separate scope of application between both conditions. As condition 11.3(a) addresses "*fees accrued up to … the Settlement Date*," it must therefore deal with amounts which have accrued up to an identified point of time (i.e., the Settlement Date). Separately, condition 11.9(a) addresses "*fees … to the extent they accrued in respect of the period before the Settlement Date*," which must therefore account for amounts which accrue by reference to a period of time, not *at* or *by* a particular time. The court inferred from this distinction that Condition 11.9(a) addresses interest and fees which may only accrue at a later date but which accrue in respect of an earlier period (i.e., prior to settlement date). Any other interpretation of Condition 11.9(a) would make the condition redundant vis-à-vis Condition 11.3(a).

Decision
The court determined that Condition 11.9(a) covered the treatment of Payment Premium, as it addressed interest and fees which may only accrue at a later date, but had accrued in respect of an earlier period. While the court felt the Payment Premium could be categorized more as "interest" as opposed to a "fee" for the purposes of Condition 11.9, it accepted the Seller's argument to treat it as a "fee," and took the view that it was almost analogous to a commitment fee, where a borrower pays a lump sum to a lender for making an advance available. Consequently, the Buyer was required to pay the Seller the Payment Premium amount that had accrued in respect of the US$11 million traded portion up to 14 Jan. 2010.

Significance
The findings of this High Court case demonstrate that settlement of a debt trade may not always signify the end of cash payments between the parties. While parties will try to reconcile amounts owed on the date of a bank debt transfer, there remain instances where future payments may still be required to be made, which debt trading parties should review as part of their pre-trade diligence.

Authored by David J. Karp.

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

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Prospecting for European Distressed Loans

DISTRESSED DEBT INVESTING

This blog will try to dissect distressed debt investing, up and down the capital structure. We will look at current distressed debt situations, try to explain the ins and outs of how decisions are made in the distressed debt world, probably rant a few times about positions that are working against me, and hopefully enlighten some readers.

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Prospecting for European Distressed Loans

It is my pleasure to introduce a new monthly contributor to Distressed Debt Investing: David Karp, partner at Schulte Roth & Zabel. David's 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 & Claims Trading Group, which provides advice in connection with U.S., European and emerging market credit trading matters. It is our pleasure to have him as a contributor.

For his entry, David discusses issues in buying and selling European distressed loans. This is an amazingly enlightening piece. I encourage all investors that are involved in Europe or are considering deploying capital to read. Enjoy!

Prospecting for European Distressed Loans

As reported throughout the financial trade press this past summer, many U.S. investors are prospecting for European distressed loans on the secondary market. While the game plan for some of these investors appears to be to invest in the fulcrum credit and implement one or more creative restructuring strategies that have been well honed by investing in the U.S., Europe is an altogether different playing field. Even as Germany, Spain, Italy and France have made recent changes to their insolvency regimes aimed at improving restructuring options — including out-of-court alternatives, debt-to-equity swaps and increased opportunities to provide debtor-in-possession financing — complex country-specific, and in many cases untested, insolvency laws and vast cultural distinctions will form the basis for a challenging recovery analysis. Before delving into recovery issues, investors must be well versed in the increased trade risks in the European market that can derail their active investment strategy just as they are getting started.

While pre-trade issues need to be vetted in numerous areas, including regulatory restrictions on lending, collateral perfection and withholding taxes, one area of great concern and complexity is whether or not the borrower's door is even open for an investment fund to become a lender via secondary market purchase. Many European borrowers view the relationship with their lender group as a private and long-term membership club completely distinct from public bond issuances, and cringe at the thought of sharing proprietary information with investment funds pursuant to a credit agreement. As a result, when European borrowers receive a request for an investment fund to enter their lender group, they are increasingly using their consent rights to deny the request and maintain control of the make-up of the group. What constitutes "consent being unreasonably withheld" is an unsettled point of English contract law, which governs most bank debt trading agreements across Europe.

What happens when a fund confirms its purchase of bank debt and the borrower subsequently doesn't provide consent for the fund to become a lender of record? The fund may be forced to settle by participation, which, in Europe, is structured as a derivative relationship. In this context, the seller is delivering an unsecured claim to a buyer referencing the underlying borrower and lender relationship. In contrast, the U.S. form of "true participation" is intended to vest the buyer with an ownership right in the proceeds the lender paid to the borrower and then passed to the participant. Loan traders entering

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the European secondary market need to be cautious as they are more likely to wind up as a participant due to consent being withheld by a borrower, which results in: (i) double credit risk (from the seller and the borrower), (ii) no privity with the borrower or ability to be active in a restructuring, and (iii) a less-liquid position than being in senior secured bonds or, for that matter, a lender of record. For many investors, this increased counterparty credit risk, decreased control and decreased liquidity is enough to ruin the investment — and the trade has not even yet settled. Investors should be especially cautious regarding this asset class because general practice in both the U.S. and U.K. secondary bank debt and claims trading markets is that a trade is binding upon oral or written agreement on material terms. (See N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii), and the recent U.K. decision of Bear Stearns v. Forum Global Equity (2007), in which the court confirmed the binding nature of a telephone conversation between traders agreeing to terms of a purchase of Parmalat notes.) In other words, "a trade is a trade."

Borrower Consent Pitfalls

Many loan agreements syndicated during the 2004–2007 high-liquidity period were drafted on "borrower-friendly," "covenant light" terms that often included, among other things, secondary transfer provisions requiring the borrower to consent to any new lender under the agreement. Increasingly, borrowers with consent rights are exercising them as a strategic measure for controlling the composition of their lending syndicate. While many loan agreements stipulate that borrower consent cannot be "unreasonably withheld," the historic lack of case law establishing what constitutes "unreasonable" behavior in a commercial context meant investors were left unsure as to whether they had legitimate grounds for challenging a borrower's refusal of consent. A recent U.K. case — in which a potential borrower sued Terra Firma Capital Partners (the private equity owners of Tank & Rast Holding GmbH, a German infrastructure group) in the High Court of England for denying borrower consent to a competitor to whom Terra Firma did not want to provide access to syndicate confidential information — was unfortunately settled out of court without any guidance from the High Court on whether Terra Firma had legitimate grounds to withhold consent. However, in the recent decision of Porton Capital Technology Funds and others v. 3M UK Holdings Ltd. and 3M Company (2011), the High Court in England did set out certain guidelines (based in landlord-tenant case law) for determining whether consent was unreasonably withheld in the given circumstances. Applying these guidelines to secondary bank debt transactions, where borrower consent is withheld and subsequently challenged as being unreasonable, the following approach may be utilized by the courts when making a determination:

1. The burden is on the proposed new lender to prove that withholding of consent by a borrower was unreasonable;
2. A borrower does not need to show that its refusal of consent was right or justified, simply
3. In determining what is reasonable, the borrower may have regard to its own interests;
4. A borrower with consent rights is not required to balance its own interests with those of the proposed new lender or to have regard to the costs that the proposed new lender might be incurring.

While there is still little case law on this approach, the findings in Porton merit attention from the bank debt community as to a rejected prospective lender's uphill climb when disputing borrower consent refusals in the U.K. When a prospective assignee is unable to obtain the necessary borrower consent to become a lender under the loan agreement, it must often rely on settlement via participation, sub-participation or some other alternative mutually agreed-upon structure.

Status of Participations in U.K. v. U.S. (LMA v. LSTA)

The Loan Market Association ("LMA") and Loan Syndication and Trading Association's ("LSTA") mandatory settlement provisions dictate that if a trade cannot settle by legal transfer, there will be an automatic "fall-back" to settlement via funded participation. The LMA form of funded participation is governed by English law and contemplates a debtor/creditor relationship between the seller (grantor) and buyer (participant). Under

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agreement, nor any relationship with the borrower. Instead, the buyer has only a right to receive the economic equivalent of any payments made by the borrower under the credit agreement, with the seller passing on such amounts to the buyer pursuant to the terms of the participation agreement. As the participant has no interest in the underlying debt, it has no contractual standing against the borrower if the borrower defaults under any of its payments. Additionally, the buyer also bears credit risk exposure against the seller should the seller become insolvent during the life of the participation. In such a scenario, the buyer only has an unsecured claim against the seller under the funded participation and cannot claim a proprietary interest or entitlement in or to the underlying loan proceeds. The result of this structure for the buyer is a "double credit risk" scenario, placing the buyer in an inherently more risky position than if it were to acquire bank debt by way of an LSTA "true participation" arrangement.

The LSTA form of funded "true participation" is a New York law governed structure, intended to give the buyer an ownership interest in the actual proceeds paid by a borrower to the seller. Whether a participation constitutes a "true participation" under New York law is a fact-based analysis that takes into account various factors including, among others: (i) the relevant language of the underlying agreement, (ii) the amount of control the seller retains or is perceived to retain over the assets after the closing of the relevant transaction and (iii) whether the transaction shifts the risks of loss and/or benefits of ownership to the transferee. The LSTA form intends to meet this criteria and assign the participant all of the rights of grantor to payment under the loan agreement. In the event that the grantor becomes subject to insolvency proceedings, payments are intended to be isolated from its insolvency estate, resulting in more limited counterparty credit risk for a participant under a "true participation." This structure was recently tested and proven effective in the Chapter 11 case of Lehman Brothers Commercial Paper when the Bankruptcy Court issued an order establishing that all "all cash, securities and other property distributed or payable in respect of true participations or sub-participations ... are not property of the Debtor's estate and shall be promptly turned over to the beneficial holders thereof." (Emphasis added; see In re: Lehman Commercial Paper Inc., 08-13900 (S.D.N.Y. Oct. 6, 2008) (Order Pursuant to Sections 105(a), 363(b), 363(c), and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing Debtor to (A) Continue to Utilize its Agency Bank Account, (B) Terminate Agency Relationships)).

There was some initial concern among investors that LMA-style participations would be subject to additional regulation under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in the U.S. due to the derivative nature of such participations, which would have subjected loan participations even partially conducted in the U.S. to U.S. federal securities law including anti fraud and anti manipulation rules potentially rendering ineffective big boy provisions relied on by the market. However, carve-outs to Dodd-Frank for LMA-style loan participation were created by the Commodity Futures Trading Commission ("CFTC") and the Securities Exchange Commission ("SEC") (collectively, the "Commissions") in response to lobbying efforts of the LMA and LSTA. While, initially, the Commissions provided a carve-out only for "true" participations, after an additional push from the LMA, they came back with a formulation that carved out all participations. The Commissions jointly adopted new rules and interpretations to define the terms "swap" and "security-based swap" found in Section 721 of Dodd-Frank, specifically excluding from these definitions certain contracts, including loan participations.

In order to qualify for this exclusion, a loan participation must "represent a current or future direct or indirect ownership interest in the loan or commitment that is the subject of the loan participation." Per the final regulations, four characteristics must be present:

1. The grantor of the loan participation is a lender under, or a participant or subparticipant in, the loan or commitment that is subject of the loan participation;
2. The aggregate participation in the loan or commitment does not exceed the principal amount of such loan or commitment;
3. The entire purchase price for the loan participation is paid in full when the loan participation is acquired and is not financed; and

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4. The loan participation provides the participant all of the economic benefit and risk of the whole or part of the loan or commitment that is the subject of the participation.

While this exclusion provides comfort to investors in loan participations that their investments will not be subject to Dodd-Frank, it serves to highlight the distinction between LMA-style participations and "true" participations.

Investor Take-aways

While investors can attempt to negotiate additional terms at the time of trade that enable them to walk away from a trade if legal transfer cannot be effected, the effort will likely be met with resistance and difficult to achieve as standard operating procedure. Alternatively, if the overall aim is to take on larger bank debt exposure against a particular borrower, it may be best to commit to a minimum threshold piece first as a way to discern how difficult the transfer process is going to be. However, it is important to note that in many European credit facilities, an existing purchase does not grant lenders an automatic right to increase their position and bypass borrower consent.

Ultimately, like many European trade issues, borrower consent risk needs to be actively managed on a case-by-case basis. It is crucial for investors to address this issue before saying "Done" or they will be fighting an even steeper uphill battle with both their counterparty and the borrower.

David J. Karp is a partner 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 & Claims Trading Group, which provides advice in connection with U.S., European and emerging market credit trading matters. David is an avid speaker and writer on distressed investing related issues, recently co-authoring "European Insolvency Claims Trading: Is Iceland the Paradigm?" for Butterworths Journal of International Banking and Financial Law and "Trade Risk in European Secondary Loans" for The Hedge Fund Law Report. David is an active member of the LMA, APLMA, INSOL Europe and the LSTA where he is a member of the Trade Practices and Forms Committee. Jamie Schwartz, an associate at SRZ, assisted in the preparation of this entry.

Distressed Debt & Claims Trading Developments

Schulte Roth&Zabel

Distressed Debt & Claims Trading Developments

spring 2012

Short Selling Bank Debt Still Remains a Gray Area

On Dec. 22, 2011, the Supreme Court of the State of New York for New York County granted summary judgment to Goldman Sachs Lending Partners LLC ("GS") against High River Limited Partnership ("High River") concerning GS's purchase of Delphi Corporation's ("Delphi") "Tranche C" bank debt (the "Bank Debt").[1] The court held that High River, as the seller, was in breach of its contractual obligations when it failed to deliver the Bank Debt to GS, the buyer, prior to a rights offering record date, even though the trade documentation did not specify a delivery date. While the court's decision did provide guidance to loan market participants on the meaning of certain of the Loan Syndication and Trading Association's ("LSTA") Standard Terms and Conditions ("STC"), it also left uncertainty with respect to the scope of a buyer's rights to participate through its seller in a rights offering first formulated after the trade date. High River has appealed the decision to the Appellate Division for the First Department.

Background

In July 2009, High River agreed to sell to GS a $140 million piece of the Bank Debt (the "Trades"), pursuant to LSTA trade confirmations for distressed trades (the "Trade Confirmations"), which incorporated the STC. However, High River did not own any of the Bank Debt; rather it was short selling the Bank Debt. On July 30, 2009, the bankruptcy court

[1] *Goldman Sachs Lending Partners, LLC v. High River Ltd. P'ship*, No. 603118/09, 34 Misc. 3d 1209(A), 2011 WL 6989894 (N.Y. Sup. Ct. Dec. 22. 2011).

see ***Short Selling Bank Debt*** on page 4

Loan Market Association Moves to Bolster European Secondary Market Liquidity

In a strong signal to secondary market participants that European loan investors' concerns are being heard, on Feb. 7, 2012, the Loan Market Association ("LMA") released a note reminding primary market participants of ways that structuring primary documentation can negatively impact secondary market liquidity.[1] Some of the considerations addressed include:

1. Transferability restrictions in the loan documentation, and ensuring that there is sufficient access for secondary investors to accede;
2. Consultation and consent requirements by a borrower, and if they exist, suitable timeframes for a borrower providing consent, as well as the practical effect on settlement times for secondary trades if borrower consent is simply required to be "not unreasonably withheld";[2]
3. Minimum transfer and minimum hold amounts and their impact on secondary investor access to the secondary market;
4. Transfer fees and the potential disincentive these

[1] Please email us at SRZDebtTradingTeam@srz.com for copies of our in-depth article on European loan market trading and/or further information on the LMA note "Documentation Issues Impacting on Secondary Market Liquidity — Considerations for Primary Market Participants."

[2] See "A Step Toward Clarifying European Borrower's Consent Rights" on page 6.

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Recognition of Trustee Filing in French Insolvency Safeguard Proceedings

In a decision that represents a triumph for bondholders, and should provide comfort to market participants, the Supreme Court of France (the "Supreme Court") has recognized the trust structure and the parallel debt mechanism as part of security packages put in place for secured international financings granted to a French company.

On Sept. 13, 2011, the Supreme Court clarified certain key questions in the context of international financing by confirming that trust and parallel debt structures governed by New York law would be recognized in France, allowing a trustee under an indenture to file a proof of claim within French safeguard proceedings ("Procédure de Sauvegarde"). Safeguard proceedings are a French legal remedy allowing a company that is facing long-term financial distress to facilitate a restructuring. The restructuring proposals are set out in a safeguard plan. In order to benefit from the plan and any recovery, each creditor must file a formal proof of claim. Under French law, only a direct creditor or a specially appointed proxy can file a proof of claim.

In the *Belvedere* case,[1] Belvedere SA ("Belvedere"), an alcoholic beverage company based in France, issued €375 million floating rate notes due in 2013. The bond documentation was entered into by Belvedere, seven of its Polish subsidiaries, a U.S. bank as trustee (Bank of New York Mellon) and two separate banks as principal and ancillary security agents (Natixis SA and Raiffeisen Bank Polska, respectively). The Belvedere entities also entered into a collateral sharing agreement in favor of each of the two security agents. The collateral sharing agreement created parallel debt in the same amount of debt owed to the trustee, but with the security attached to it. This structure is commonly used in cross-border transactions for jurisdictions where the trust concept is not recognized (such as France) and allows, when necessary, the security agents to foreclose over the secured assets of a company for the benefit of the bondholders. Both the bond documentation and collateral sharing agreement were governed by New York law.

On July 16, 2008, the Commercial Court of Beaune opened French safeguard proceedings for Belvedere SA and its Polish subsidiaries. Three proofs of claim were filed, one by the trustee and the remaining two by the security agents, and all claims were for the full amount of the notes. These claims were admitted by the Commercial Court. Belvedere and its Polish subsidiaries challenged the admission of the trustee claim, arguing that, in accordance with French law, the trustee was not the legal owner of the receivables, but only a proxy acting for the bondholders without having been specially appointed. Belvedere also challenged the claims filed by the security agents on the grounds that the parallel debt could lead to double payment in contradiction with French public policy.

On appeal, the three proofs of claim were upheld by the Dijon Court of Appeal in its decision dated Sept. 21, 2010, and on the grounds that the trustee was not acting as the bondholders' specially appointed proxy but rather as the legal owner and therefore valid creditor of the receivables in accordance with New York trust law. The Court of Appeal also rejected the public policy argument raised by Belvedere SA in relation to the filing by the security agents.

Belvedere then filed a further challenge to the Commercial Chamber of the French Supreme Court. The French Supreme Court was asked to resolve a conflict of law issue and determine whether the legal capacity of the trustee to file a proof of claim in Belvedere's safeguard proceedings was governed by contract law (New York law in this instance), or by French law governing the insolvency proceedings. Under French law, the trustee would have to be appointed as a special proxy by the bondholders to declare claims on their behalf. However, this had not been done since the trustee was deemed to be the legal owner of the receivables as a matter of New York trust law. If the Supreme Court recharacterized the trustee as a proxy, the filing of the proof of claim on behalf of the bondholders would have been inadmissible in the safeguard proceedings, and the bondholders would have been unable to benefit from the provisions of the safeguard plan including any distribution of dividends.

In its decision dated Sept. 13, 2011, the French Supreme Court approved the decision by the Court of Appeals, upholding the proof of claims filed by the trustee and both security agents. In respect of the filing by the trustee, the Supreme Court reconciled the conflicting legal positions by determining that the "lodging, verification and admission of claims" as set out in article 4.2(h) of EC Regulation 1346/2000 (codifying the manner in which a European Union member state determines whether it has jurisdiction to open insolvency proceedings) must be made pursuant to French insolvency law, but that the question as to whether the trustee was the owner of the receivables must be determined according to New York law, governing all the agreements. In reaching this decision, and by allowing the proofs of claim to be retained, the bondholders were able to participate in the distributions that came about from the safeguard plan.

*see **Recognition of Trustee Filing** on page 5*

[1] *Cour de Cassation, chambre commerciale, audience publique du Mardi, 13 Septembre 2011, No de pourvoi: 10-25533, 10-25731, 10-25908*. The judgment is accessible at www.legifrance.gouv.fr/initRechJuriJudi.do (note: the website is in French only).

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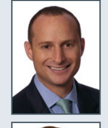

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New Disclosure Requirements for Ad Hoc Groups and Committees

Revised Bankruptcy Rule 2019, which governs disclosure requirements for groups and committees in Chapter 9 and 11 bankruptcy cases, went into effect on Dec. 1, 2011. The following is a summary of a few key facets of the new rule.

Who?

The new Rule 2019 requires certain disclosures by "every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity securities holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another." The broadened scope of the rule puts an end to the ongoing debate under the prior rule as to whether it applied to ad hoc "groups" or only to formal committees. However, revised Rule 2019 leaves open the meanings of "acting in concert" and "common interests," adding back some uncertainty as to the rule's applicability (and providing a means for clever participants to structure their dealings with other creditors so as to avoid coming under the rule for as long as possible). Importantly for debt lenders and secondary-market participants, the rule specifically exempts indenture trustees and credit agreement agents from the new disclosure requirements.

What?

A Rule 2019 disclosure statement now must include the "pertinent facts and circumstances" related to the formation of the group or committee, including the name of each entity that caused the formation or for what entities the group or committee is acting. The statement must also include each member's name, address, and the nature and amount of its "disclosable economic interest" as of the date of formation. The rule defines disclosable economic interest as "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." Although not specified in the rule, the Advisory Committee notes indicate that the definition is intended to be broad enough to incorporate short positions, CDSs and TRSs. This expansive scope is a critical element of the new rule, as a driving force behind the move to revise Rule 2019 was a concern that members of groups or committees could be outwardly active in the reorganization process while having (unbeknownst to the debtor or other creditors) larger,undisclosed short positions, such that the members would derive a greater benefit from the debtor's failure than from a successful restructuring. Importantly, the rule does not require the disclosure of the price or the timing of the entities' coming into the interest.[2]

[2] The new Rule 2019 does require disclosure of the quarter and year of an entity's acquisition if the group or committee is claiming to represent entities that are not members of the group or committee, unless the interest was acquired more than a year before the petition date. This may lead groups and committees to no longer claim they are representing silent class members.

*see **New Disclosure Requirements** on page 6*

Short Selling Bank Debt *continued from page 1*

overseeing Delphi's bankruptcy case modified Delphi's confirmed plan of reorganization (the "Plan") providing for the sale of substantially all of Delphi's assets to DIP Holdco 3 LLC ("Holdco"). Under the Plan, holders of the Bank Debt would receive one or more distributions of cash, which would be less than the face amount of their claim.

In connection with effectuating the Plan, Holdco circulated a memorandum (the "Memorandum") on Aug. 25, 2009 describing Holdco's offer to holders of certain tranches of Delphi's bank debt to exchange their right to cash distributions under the Plan for certain interests in the entity succeeding to Holdco, including an equity interest, unsecured subordinate notes and term loan commitments under a new delayed draw credit facility (the "Rights Offering"). The Memorandum set a record date of Sept. 10, 2009 (the "Record Date") for eligibility to participate in the Rights Offering.

GS expected to participate in the Rights Offering as a lender of record by settling the trades prior to the Record Date, and GS and its counsel attempted several times to contact High River and its counsel to demand settlement of the Trades prior to the Record Date. On Sept. 3, 2009, High River's counsel informed GS that they would not be able to close the Trades prior to the Record Date. Thereafter, GS sent High River a draft letter agreement requesting High River to represent that it would subscribe to the Rights Offering on behalf of GS. Such a letter agreement typically provides that a seller will subscribe to a rights offering on behalf of a buyer and the buyer will pay for such subscription prior to any funding deadline in addition to indemnifying the seller for its actions on behalf of the buyer. Many secondary loan market participants use this type of letter agreement when their trades fail to settle before a record date for a rights offering. High River did not sign GS's proposed letter agreement.

After Holdco had announced the Rights Offering, but prior to the Record Date, GS had sold the Bank Debt it was purchasing from High River to third parties. Unlike the language in High River's Trade Confirmations, the purchasers of the Bank Debt from GS apparently had included specific language entitling them to the proceeds of the Rights Offering as part of their trades. To satisfy its obligation to these downstream purchasers of the Bank Debt, GS subsequently purchased the right to receive the Rights Offering proceeds on the secondary market at a higher price than the Trades. GS then sued High River to recover its damages.

The Court's Decision

The court held that High River had breached its obligations under the Trade Confirmations when it failed to deliver the Bank Debt prior to the Record Date, even though the Trade Confirmations did not reference a specific date by which the Trades were to have settled. Each of the Trade Confirmations provided that settlement was to occur "as soon as practicable," to which the court gave the plain meaning interpretation "speedily." In the context of the Trades, the court stated that this language required High River to settle the Trades by the Record Date. The court found that High River did not deliver, and could not have delivered, the Bank Debt by the Record Date, because High River: (1) never owned the Bank Debt necessary to settle the Trades; (2) never entered into a trade to purchase the Bank Debt; (3) never sought to purchase the Bank Debt on the open market; and (4) failed to deliver the Bank Debt. The court further stated that it would have been feasible for High River to close the Trades by the Record Date if it had owned or purchased the Bank Debt.

In its counterclaim, High River argued that GS breached the Trade Confirmations, because GS was obligated to purchase the Bank Debt "as such Debt may be reorganized, restructured, converted or otherwise modified." According to High River, while the Plan converted the Bank Debt into cash distributions only, the Rights Offering was separate from the Plan, and the Rights Offering was offered by Holdco and not by Delphi. In an effort to settle the Trades by alternate means, High River had offered GS a cash amount equal to the amount that the Bank Debt would have received under the Plan. This offer was equivalent to approximately $0.16 per dollar of Bank Debt — much less than GS's purchase rate for the Bank Debt in the Trades. Thus, High River argued, it had satisfied its obligation under the Trade Confirmations and GS was in breach when it refused to settle the Trades on cash proceeds. The court disagreed, stating that High River remained obligated to "proceed in good faith to close the trade by 'assignment' and 'as soon as practicable' following the trade date." Further, the court found that High River never "delivered the Bank Debt to [GS]" and, therefore, was precluded from claiming that GS had breached its obligations under the Trade Confirmations.

Commentary

The court found that High River breached its obligations to settle the Trades "as soon as practicable" when it failed to deliver the Bank Debt prior to the Record Date. However, whether correct or not, the court neither analyzed a number of key facts nor clarified two questions of concern to the secondary bank debt market: (1) how quickly do short sellers have to cover their short trades (short selling in the loan market is not presently regulated nor subject to any rules); and (2) does entering into a trade entitle

see ***Short Selling Bank Debt*** *on page 5*

Short Selling Bank Debt *continued from page 4*

buyers to receive the right to subscribe to a rights offering or the proceeds of a rights offering when the rights offering is announced after the trade date.

As noted, sellers generally will work with buyers to grant access to a rights offering when they are precluded from participating based on a record date, in certain instances, even if that access is not contracted for in the trade confirmation. However, without express terms in the trade confirmation requiring the seller to subscribe, such a buyer may not have the leverage to negotiate acceptable terms for access to the rights offering and the decision did not clarify whether such rights are part of rights associated with the debt transferred from seller to buyer, which can be different for buyers to ascertain especially when as in this case, a rights offering has not been announced to the market at the time of trade.

The court focused on High River's failure to "deliver the Bank Debt" before the Record Date, or deliver the Bank Debt "as reorganized, restructured, converted, or otherwise modified," including the proceeds of the Rights Offering. The court appears to have presumed that participation in the Rights Offering was expressly required, rather than optional, for holders of the Bank Debt and not considered the market practice of signing a letter agreement in which a seller and buyer contract for the seller to subscribe on behalf of a buyer at the time of trade. In addition, the court apparently did not distinguish between a rights offering as part of a plan of reorganization and a rights offering offered subsequently to the holders of claims by a non-debtor entity. Although the court did not address these issues directly, its decision could be read to require sellers to either: (1) ensure that their trades settle on or before a rights offering's record date; or (2) subscribe to such rights offering on behalf of its buyer, without the benefit of such a letter agreement.

Loan market participants should note that the LSTA recently introduced "Distressed Buy-In/Sell-Out" ("Distressed BISO"), which went into effect on Sept. 9, 2011. Distressed BISO is intended to give a loan market participant leverage over its trade counterparty, when that counterparty has held up settlement of the trade.[2] In this case, even if the Trades had been subject to Distressed BISO, this would likely not have changed the outcome. Under Distressed BISO, a so-called performing party can buy-in or sell-out of a trade (as applicable), when its counterparty remains a so-called "non-performing party" beyond the Distressed BISO trigger date (i.e., 50 days after the trade date). On the one hand, in this scenario, GS would not have been able to rely on Distressed BISO, because the Record Date was less than the required 50 days after the Trade Date, after which a party could have triggered Distressed BISO. On the other hand, had the Trade Confirmations been subject to Distressed BISO and the Record Date had been after the Distressed BISO trigger date, then High River, as a short seller who did not enter into a buy trade within T+5, could not rely on its open, upstream trades to shield itself from a buyer's Distressed BISO notice.

Take-Aways

While this decision is being appealed, participants in the secondary loan market may want to consider the following in the context of future trades:

- When buying debt that is subject to a bankruptcy proceeding or other restructuring, a buyer should include clear language in the trade confirmation specifying that it expects the seller to subscribe to any rights offering or other subscription offered through a plan, the borrower, the agent or otherwise, even if no such rights offering or subscription has been announced at the time of the trade.
- Short sellers of bank debt should be wary of developments or dates related to the credit, as it now may be necessary to cover the short before any deadline or record date. ■

Recognition of Trustee Filing *continued from page 2*

As for the parallel debt argument, the Supreme Court also rejected the argument raised by Belvedere SA, according to which the filing of the parallel debt by the security agents could lead to double payment in contradiction with French public policy, on the ground that the contract specifically provided that any payment made to the security agents would reduce the main debt accordingly. ■

[2] Distressed BISO is further discussed in SRZ's Distressed Debt & Claims Trading Developments Summer 2011 newsletter, available at: http://www.srz.com/081111_Distressed_Debt_&_Claims_Trading/.

Loan Market Association continued from page 1

could have on investors considering acquiring an interest in a particular loan;

5. Ability for bank debt transfers to be conducted on a non pro rata facilities basis, to ensure maximum flexibility for buyers to acquire their preferred facilities;
6. Use of pro-rata interest settlement (i.e., where the agent pays interest to each lender of record during its period of ownership) to reduce administrative burdens between buyers and sellers; and
7. Avoiding executing transfer documentation in the form of a deed for transfer documentation (unless required by local law) as the formalities required to execute by deed can be burdensome and may delay the settlement process.

While it remains to be seen how these issues will be factored into primary documentation, the release of the note clearly demonstrates recognition by the LMA that a robust and liquid secondary loan market is vital for the long-term sustainability of the syndicated loan market. ■

New Disclosure Requirements continued from page 3

When?

The disclosure requirement under new Rule 2019 is triggered as soon as members of a group or committee begin "acting in concert to advance their common interests" without the necessity of the members becoming active in the case or taking a position before the court. Further, after a group or committee has filed a Rule 2019 statement, it will be required to file a supplemental statement whenever it takes a position before the court, if there have been any material changes to its prior disclosure.

What Is the Impact?

Failure to comply with the new Rule 2019 can have serious ramifications. Any party in interest may seek a determination, or the bankruptcy court itself may inquire on its own, whether there has been a failure to comply with the rule. If the court finds such a failure, it may: (1) refuse to permit the group or committee to be heard or to intervene in the case; (2) "hold invalid any authority, acceptance, rejection, or objection given, procured, or received by the group of committee"; or (3) fashion any other relief it deems appropriate. Given the breadth and nature of the new disclosure requirements and the potentially serious consequences of non-compliance, a creditor or equity holder needs to carefully consider whether the benefits of concerted action, such as increased influence and shared counsel fees, outweigh the associated burdens imposed by the revised rule. ■

A Step Toward Clarifying European Borrower's Consent Rights

Investors looking to become active in a European company's restructuring will often have to first acquire a sizable debt position under the relevant senior secured loan agreement. This is generally not a straightforward process and can be fraught with uncertainty. Many loan agreements syndicated during the 2004-2007 high-liquidity period were drafted on "borrower-friendly" terms, often including, among other things, secondary transfer provisions requiring the borrower to consent to any proposed new lender under the agreement.[3]

Borrower consent rights can pose major barriers for investors trying to accede as secondary lenders under a loan agreement and gain direct exposure to European bank debt. If a trade was conducted on Loan Market Association ("LMA") documentation, mandatory settlement provisions could leave the investor having to settle via a funded participation, or some alternative means, so that the investor is left with economic risk exposure against the borrower and its trading counterparty (the existing lender of record) but without a voice on any future restructuring.

More and more frequently, borrowers granted consent rights under loan agreements are exercising them as a strategic measure of controlling the composition of their lending syndicate. While many loan agreements stipulate that any borrower consent .cannot be "unreasonably withheld," the historic lack of case law establishing what constitutes unreasonable behavior in a commercial context meant investors were left unsure whether they had legitimate grounds for challenging a borrower's refusal of consent.

[3] See "Loan Market Association Moves to Bolster European Secondary Market Liquidity" on page 1.

see A Step Toward Clarifying on page 7

A Step Toward Clarifying *continued from page 6*

However, recent case law may begin to resolve the uncertainty. In the recent decision of *Porton Capital Technology Funds and others v. 3M UK Holdings Ltd. and 3M Company* (2011), the High Court in England applied consent principles well established in landlord and tenant property cases for resolution in a commercial contract dispute. The dispute involved the sale of a company, where a substantial part of the sale proceeds were payable based on an earn-out period after completion. In rendering its judgment, the High Court set out certain guidelines for determining whether consent was unreasonably withheld in the given circumstances. Applying these guidelines to a secondary bank debt transaction, where borrower consent is withheld and subsequently challenged as being unreasonable, the following approach may be utilized by the courts when making a determination:

1. The burden is on the proposed new lender to prove that the withholding of consent by a borrower was unreasonable;
2. A borrower does not need to show that its refusal of consent was right or justified, simply that it was reasonable in the given circumstances;
3. In determining what is reasonable, the borrower may have regard to its own interests; and

A borrower with consent rights is not required to balance its own interests with those of the proposed new lender or to have regard to the costs that that proposed new lender might be incurring.

While there is still little case law on this point, the High Court decision in *Porton* may provide guidance to investors. The findings merit attention from the bank debt community as to a rejected prospective lender's uphill climb when disputing borrower consent refusals. ■

Bankruptcy Claims Trading: Volume Record in February and Value Record in March

Top 10 Actively Traded Bankruptcy Cases – March 2012

By Dollar Amount of Claims Traded

Bankruptcy Case	Trades	Amount	Avg. Amount
Lehman Brothers Holdings, Inc.	981	$5,839,360,971	$5,952,458
MF Global, Inc.	104	$325,800,321	$3,132,695
Motors Liquidation Company	2	$41,229,324	$20,614,662
Nortel Networks, Inc.	29	$5,408,714	$186,507
Mervyn's Holdings LLC	7	$3,239,429	$462,776
Circuit City Stores, Inc.	4	$3,042,420	$760,605
Lehman Brothers Inc.	5	$3,003,516	$600,703
Hussey Cooper Corp.	5	$1,729,432	$345,886
Hostess Brands, Inc.	22	$1,453,524	$66,069

By Number of Claims Traded

Bankruptcy Case	Trades	Amount	Avg. Amount
Lehman Brothers Holdings, Inc.	981	$5,839,360,971	$5,952,458
AMR Corporation	135	$1,448,743	$10,731
MF Global, Inc.	104	$325,800,321	$3,132,695
SP Newsprint Holdings LLC	30	$696,349	$23,212
Nortel Networks, Inc.	29	$5,408,714	$186,507
Energy Conversion Devices, Inc.	26	$167,201	$6,431
Hostess Brands, Inc.	22	$1,453,524	$66,069
Innkeepers USA Trust	18	$25,210	$1,401
W.R. Grace	16	$125,736	$7,858

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About SRZ's Distressed Debt & Claims Trading Practice

SRZ's Distressed Debt & Claims Trading Group has extensive experience advising broker-dealers, hedge funds, investment banks, CLOs and private equity funds on a wide range of U.S., European, Asia-Pacific and emerging markets debt and claims trading matters. When not managed properly, trade and transfer risk issues can push a potentially winning investment into losing territory. Our attorneys understand our clients' goals and have the transaction skills and commercial sense required to facilitate timing execution and settlement of trades. The group advises clients in structuring, preparing and negotiating deal-specific transaction documentation including: trade confirmations, debt and post-reorganization equity purchase and sale agreements, claim assignment agreements, participation agreements, proceeds letters, confidentiality agreements, "big boy" letters, and bid procedure documentation. **For more information about the practice, visit www.srz.com/Distressed_Debt_Claims_Trading/**.

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LBIE Update — UK Supreme Court Upholds Decision Expanding Client Money Pool Scope and Eligibility

Schulte Roth & Zabel

Alert

LBIE Update — UK Supreme Court Upholds Decision Expanding Client Money Pool Scope and Eligibility

March 1, 2012

On Feb. 29, 2012, the Supreme Court (the "Supreme Court"), the UK's highest court, issued a majority decision upholding the U.K. Court of Appeal's Aug. 2, 2010 ruling[1] regarding the scope of, and participation in distributions from, the Lehman Brothers Europe (International) ("LBIE") pool of client money.[2] The Supreme Court's landmark decision applies to all customers who agreed with their investment firm counterparty that their money would be treated as client money under the U.K.'s Financial Services Authority's Rules (the "FSA Rules"), whether or not such money was actually segregated by the investment firm in accordance with the FSA Rules. The decision thus may impact not only holders of client money claims against LBIE, but also similarly situated holders of client money claims against MF Global UK, the London arm of futures merchant MF Global Inc.

The Supreme Court's decision: (1) expands the pool of client money, which is afforded priority treatment, to now include money that LBIE should have, but failed to, properly segregate as client money; and (2) permits clients whose money had not been actually segregated ("Unsegregated Clients") to have the same rights to distributions from the client money pool as clients whose money had been segregated properly ("Segregated Clients"). The decision affirms the Court of Appeal's ruling, which had reversed a High Court decision that held that Unsegregated Customers were not entitled to participate in the customer money pool, but would be subject to other tracing remedies available under U.K. law.

Under the FSA Rules, LBIE was required to segregate client money received from its clients (FSA Rules, CASS 7). The Supreme Court agreed with the High Court that LBIE failed to meet that requirement on a "truly spectacular scale."[3] In addition to requiring segregation of customer funds, CASS 7 creates a statutory trust over client money and, in the event of an investment firm's failure, such client money is pooled and distributed to clients on a pro-rata basis. The issues before the Supreme Court were: (1) whether the statutory trust arises on receipt of the customer funds or upon the investment firm's segregation of the funds; (2) whether the pooling requirements apply only to the segregated accounts or also to customer money not segregated from the investment firm's house accounts; and (3) whether participation in distributions from the pooled client money is only available to Segregated Customers or also available to Unsegregated Customers.

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[1] For more information on the Court of Appeal decision, see *SRZ Client Alert* (Aug. 10, 2010) "U.K. Appeals Court Expands Scope of Client Money Pool and Universe of Clients Eligible for Client Money Pool Distributions" *available at:* http://www.srz.com/081010_LBIE_Update_UK_Appeals_Court_Expands_Scope_of_Client_Money_Pool/.

[2] *In the Matter of Lehman Bros. Int. (Europe) (In Administration) and In the Matter of the Insolvency Act 1986*, [2012] UKSC 6 (appeal taken from the Court of Appeal Civil Division) (U.K.) *available at:* http://www.supremecourt.gov.uk/docs/UKSC_2010_0194_Judgment.pdf.

[3] *In the matter of Lehman Bros. Int. (Europe) (In Administration) and In the Matter of the Insolvency Act 1986,* [2010] EWCA Civ 917, at ¶ 129 (appeal taken from the Court of Appeal Civil Division) (U.K.).

The Supreme Court dismissed the appeal by majority and held that:

- The statutory trust arises at the time an investment firm, such as LBIE, receives client money and not at the time client money is actually segregated. In deciding this issue, Lord Walker noted that it would be "unnatural and contrary to the primary purpose of client protection" for such money to stop being treated as the client's property when the investment firm received the funds and then to become treated as the client's property again upon segregation;[4]
- The pooling requirements apply to all client money, including identifiable client money deposited in house accounts and not properly segregated in client accounts. Lord Walker and Lord Dyson agreed[5] on this issue and reasoned that the purpose of the CASS 7 scheme was to provide a high level of protection for all clients and client money held in each money account of the firm. That purpose would be frustrated if the pool were arbitrarily limited by the "happenstance" of whether the firm has segregated the money; and[6]
- A client's participation in distributions from the client money pool is not dependent on whether the client's money actually had been segregated. The three lords forming the majority applied a purposeful interpretation approach, reasoning that the purpose of CASS 7 is to safeguard the assets of *all* clients.[7]

The decision likely will result in the dilution of the Segregated Clients' expected distributions from the customer money pool and will lead to increased uncertainty, and potentially litigation, over exactly which (previously unsegregated) funds should be added to the customer money pool and precisely who is entitled to a share of the pool. Lord Walker acknowledged that distribution of client money by the LBIE administrators in accordance with the Supreme Court's decision would be complex and would take a long time to complete on account of the extraordinary circumstances of LBIE's case. In other cases, Lord Walker noted, "the position might well be very different" and it would not be right to allow the "scale of the exercise" to lead to a solution contrary to the purpose of CASS 7.[8]

The decision represents a positive development for the estate of the U.S. broker-dealer, Lehman Brothers Inc. ("LBI"), whose liquidation trustee has been urging client money protection for property of LBI customers whether properly segregated or not. It is also a welcomed decision for certain customers of MF Global UK, who claim that their funds should have been, but were not, properly segregated prior to the commencement of that firm's Special Administration proceedings.

Authored by Lawrence V. Gelber, Ron Feldman and Neil S. Begley.

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

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[4] *See id.* at ¶ 63.

[5] *See id.* at ¶ 113.

[6] *See id.* at ¶ 165.

[7] *See id.* at ¶ 159.

[8] *See id.*

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Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans

The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 4, Number 37 October 21, 2011

Distressed Debt

Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans (Part One of Two)

By David J. Karp, Roxanne Yanofsky and Erik Schneider, *Schulte Roth & Zabel LLP*

For the majority of 2011, European secondary loan markets had buy-side traders frustrated by low liquidity, volume and deal flow, and sell-side traders were left to wonder if and when they do source, will enough friends come out and play.[1] Is this the calm before the storm? We, along with many in the distressed community, believe it is, and that loans will play a significant role in the corporate distressed wave expected to hit shore in 2012 as part of €221 billion worth of European leveraged loans set to mature between now and through 2015.[2] The high yield market was a savior in 2011 for many borrowers whose loans were set to mature in 2013 and 2014. However, with some of these deals already having gone sour and the pool of remaining loans deteriorating, the high yield market is not likely to save the day again. Regardless of the capital market options, when the refinancing peak reaches its heights in Europe and the U.S. in 2014, bad loans will likely be left behind in droves. To assist investment funds in filling their proverbial sandbags and preparing to pick up potentially lucrative pieces in the aftermath, we are delivering a two part series on trade risk specific to loans in the European market.

Though similar in many of their underlying principles, the secondary markets for European distressed debt and claims trading differ in many important respects from the U.S. markets, including a much higher degree of trade risk. Investment funds looking to Europe must thoroughly review and consider these distinctions, and may also find that in many instances, and for a multitude of reasons, they are not welcomed into a credit or to the restructuring table. Until recently, many European jurisdictions had been closed off from external secondary debt financing as a result of an underdeveloped market, unsupportive regulatory regime or limited and illiquid "club deals" involving only a few select banks. Today, many jurisdictions and borrowers are still not rolling out the welcome mat and U.S. investors should recognize that investing in Europe is not as straightforward as copying U.S. strategies and procedures.

The elevated level of trade risk in Europe is due in no small part to the number of jurisdictions typically involved in any given trade. Although the Loan Market Association's ("LMA") English law governed documentation is used as a template for secondary market trades in over 40 different countries,[3] other jurisdictions often govern the underlying loan agreement or a borrower's insolvency proceedings and can also play a role in a trade. These variables – combined with the fact that a typical European secondary debt trade often includes a buyer, seller and one or more borrowers based in different jurisdictions (each administered by a different set of operational rules, customs and procedures) – require traders to dig deep into the details before they pull the trigger. Failure by investors to fully account for such risks before entering a trade can cause winning trades to quickly slip into losing territory.

While careful post-trade drafting can reduce certain trade risks after a deal is struck, investors should endeavor to

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www.hflawreport.com Volume 4, Number 37 October 21, 2011

address material trade risks before the trade is agreed. Timing is important because similar to the Loan Syndication and Trading Association's ("LSTA") protocol in the U.S. loan markets, the LMA operates in accordance with the principal of "a trade is a trade." As such, once a buyer and seller say "done," they will be contractually bound to settle the trade, even if they later discover a material issue affecting the trade that the parties failed to specifically address upfront. In order to reduce trade risk at the outset, the buyers and sellers should consider the following issues before entering into a trade:

1. Regulatory Lender Restrictions – what jurisdictions and applicable lender restrictions play into a trade;
2. Tax – will the debt purchase make an investor subject to a withholding tax, and, if so, can it obtain the benefit of an exemption or a reduced rate of withholding tax;
3. Loan Agreement Requirements – what are the requirements to accede as a lender of record under a loan agreement, including: (i) eligibility requirements; (ii) minimum thresholds; and (iii) borrower consent rights;
4. Transfer Perfections – any additional steps an investor must take to perfect its debt transfer and consequences for failing to take the requisite action;
5. LMA Transparency Guidelines – trading on the basis of Borrower Confidential Information versus Syndicate Confidential Information;
6. Trade Documentation – should the traded debt be documented on par, distressed or claims documentation;
7. Form of Transfer – is legal transfer preferable to an alternative form of settlement; and
8. Additional Terms of Trade – are additional modifications to the LMA standard terms and conditions required.

This first article will focus on certain macro issues arising in the context of European secondary loan trading, through analyzing regulatory, tax and credit documentation factors which can impact the success of a trade, as set out in topics (1) through (4) above. The second article, to be published in an upcoming issue of The Hedge Fund Law Report, will look at trade issues affecting an investor at time of trade and on a more micro level, covering the remaining topics (5) through (8) above.

Regulatory

Regulations impact many aspects of an investor's loan portfolio. One such aspect is a possible prohibition on any lending to a European borrower without prior regulatory authorization. If indeed necessary, an investor who fails to obtain such authorization may face civil, and possibly criminal, sanctions for any unlawful lending conduct. An investor's violation and subsequent sanction could also preclude its ability to participate in future lending and investing activity in that country on different transactions vis-à-vis new borrowers.

Investors should not assume that they are beyond the scope of any lending regulations on the basis that primary syndication is completed and funding of the borrower has already taken place. Dismissing these regulations may have damaging consequences, as there can still be instances where a secondary lender will be called upon to fund. This situation can arise in the context of a revolving credit facility, and it may also be applicable for term loans where the underlying loan agreement enables a borrower to request additional funds. Additional money fronted to a borrower in connection with a refinancing or a restructuring, or the extension of the original maturity date may also be considered a lending activity. Funding under such circumstances could trigger breaches

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of regulatory restrictions in place if the relevant jurisdiction requires an investment fund to be licensed in order to lend.

Member states within the European Union all comply with Directive No. 2006/48/EC of 14 June 2006 (known as the "Banking Consolidation Directive"), which aims to harmonize and regulate banking activities within Europe. The Banking Consolidation Directive focuses on providing certain rules for banking activities within and between the European Union member states, with such member states then taking the requisite steps to implement and adopt the measures prescribed therein through their individual legislative systems. However, and as is the case with most European Union directives, member states are often granted a certain degree of flexibility and discretion in the implementation process. The Banking Consolidation Directive is no different, providing minimum standards for the conduct of certain banking activities, with member states being able to adopt more rigorous and conservative measures in their own home state.

The Banking Consolidation Directive covers different types of banking activities,[4] though it focuses chiefly on institutions engaged in the acceptance of deposits and other repayable funds from the public, with such institutions being defined as "credit institutions." Credit institutions are required to obtain prior regulatory authorization and a banking license to be able to accept deposits from the public. The remaining banking activities set out under the Banking Consolidation Directive, including commercial lending, can be undertaken by a "financial institution," an entity which is simply set up to carry on banking activities other than the acceptance of deposits from the public. Financial institutions do not require prior regulatory authorization or a banking license (unless they are conducting other activities which would require regulatory authorization under European Union law, such as providing investment advice or managing assets belonging to clients).

However, and in accordance with the leeway provided to member states under the Banking Consolidation Directive, certain member states have implemented a broader and more encompassing definition of a "credit institution," so that other banking activities, in addition to accepting deposits from the public, are captured within the definition and are required to be authorized and licensed. France is but one example of a member state which has decided to take advantage of this flexibility, requiring that any type of lending activity be undertaken by a credit institution and therefore have prior regulatory authorization. The definition of a "credit institution" under the Monetary and Financial Code in France adopts a broader definition than that set out within the Banking Consolidation Directive, incorporating legal entities whose customary business activity is the carrying out of banking transactions, comprising the receiving of funds from the public, credit transactions, and the provision to customers, or administration of, means of payment.[5] The result of this broad definition is that an entity will need authorization, via a banking license, in order to lend to a French borrower. Similar wide interpretations of the term "credit institution" are present in Germany under the German Banking Act[6] and Italy under the 1993 Banking Law.[7] Conversely, other countries such as the United Kingdom allow financial institutions to engage in commercial lending activities without any such authorization.

Consequently, an investor looking to buy into a facility under a loan agreement should undertake a regulatory analysis of

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the relevant borrower's jurisdiction and verify whether any lending restrictions exist, and what impact, if any, they may have on the investor's proposed trade. In addition to the due diligence undertaken on the current borrower of a particular facility, investors should take note that a syndicated loan agreement based on the LMA's recommended form allows other borrowers within a borrower's group to accede or resign under specific facilities during the life of the loan agreement. The investor's regulatory analysis should therefore also cover future borrowers who may be permitted to accede under the facility as new borrowers following completion of primary syndication. Investors should consult counsel to establish the scope of any lending restrictions in place and to ensure that the investor does not run afoul of such restrictions.

Tax

Depending on the jurisdiction of the borrower and the investor, interest payments may be subject to withholding taxes levied by the jurisdiction of the borrower.[8] An investor should conduct a thorough tax analysis on any tax issues that may arise as a result of holding secondary debt under a loan agreement as the direct lender. Depending on its expected recovery, if an investor is aware at the outset that interest payments may be subject to a withholding tax, it may decide not to go through with the trade. However, if an investor does not appreciate the tax consequences until it agrees to trade, the investor will still be legally and contractually bound to settle. In that situation, an investor could possibly mitigate the tax impact by opting for a different form of settlement (for example, settlement by LMA funded participation).[9] Alternatively, if the investor is an investment fund manager, it may decide to allocate the debt to one of its funds that has the benefit of a withholding tax exemption under an applicable double taxation treaty, or the investor may also decide to purchase the debt and then sell it immediately onwards in a multi-lateral transaction, whereby the original seller transfers the debt directly to the ultimate buyer. However, in any event, each of these post-trade fixes may come with additional costs or may force the investor to sell at a loss.

Whether a withholding tax applies to interest payments will generally depend on the residency of a borrower and lender. If a withholding tax is applicable, whether taxes are withheld depends on if there are any double tax treaties or other exemptions in place that a lender can benefit from to obtain a partial or full exemption. For example, in the UK, HM Revenue and Customs imposes a 20% withholding tax on any UK source "yearly interest" payments made by a corporate borrower.[10] However, an absolute exemption from this withholding tax can apply in certain instances, which include: (i) if the person beneficially entitled to interest payable under a loan agreement is a company resident in the UK for UK tax purposes; or (ii) where HM Revenue and Customs has directed the borrower not to withhold taxes pursuant to an application under an applicable double tax treaty between the jurisdiction of the person beneficially entitled to the interest and the UK.[11] Generally, any borrower gross-up provisions under a loan agreement will not apply to secondary lenders if they are withheld against because of their tax status upon accession under the agreement.

Transfer Requirements Under the Loan Agreement

Once an investor has completed the background investigation of regulatory matters, it should conduct due diligence on the underlying loan agreement. This includes verifying whether the investor can meet any lender eligibility requirements, minimum transfer or hold requirements and borrower consent requirements. Failure to meet existing contractual

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requirements under a loan agreement may result in a buyer of debt being prohibited from acceding as a lender of record. Unlike in the U.S., these lender restrictions commonly vary between loan agreements and can set barriers to entry that are difficult for investment funds to surmount, effectively giving borrowers control over the makeup of their lending syndicate. This may force the buyer to hold the debt indirectly (for example, as a participant under a funded participation), without a clear and direct ability to influence any borrower restructurings and possibly without access to the borrower's confidential information. Alternatively, if indirect acquisition of the debt is not possible or feasible, the buyer will have to sell out, re-allocate or find some other settlement solution. Each of these alternatives brings additional administrative and legal costs, and can immediately put the overall success of the trade at risk.

Eligibility Requirements under the Loan Agreement

Loan agreements regularly contain language in their transfer provisions specifying the type of entity eligible to hold debt directly. While transfer provisions in loan agreements can be very specific, European loan agreements have traditionally been less clear on what requirements a buyer must meet to become an eligible lender.

While some U.S. borrower's loan agreements may reference the U.S. securities laws definitions of "accredited investor"[12] or "qualified institutional buyer"[13] to define eligible assignees, the language under the transfer provisions in older versions of the LMA form of loan agreement have historically been less specific, allowing existing lenders the ability to transfer debt only to "banks or other financial institutions," with neither term being defined. The LMA has sought to reconcile this ambiguity by updating its recommended form of agreement, expressly enabling a fund to become an eligible lender; transfers can now be made "to another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets."[14]

That being said, not all loan agreements include this clarified language. In particular, older credit agreements still being traded or those where the borrower had more bargaining power when agreeing to the loan may lack specific language enabling an investment fund to hold debt directly. Yet not all is bleak for an investment fund, as even if transfer provisions restrict an entity to "banks or other financial institutions," recent case law in England has provided some interpretative guidance on what constitutes a "financial institution." In 2006, the Court of Appeal (Civil Division) England handed down judgment in the case of *Essar Steel Ltd v. The Argo Fund Ltd* [2006] EWCA Civ 241, giving a wide interpretation to the definition of a "financial institution" and stating the entity did not have to be a bank or even akin to a bank to satisfy this term.[15] While this case has provided comfort for investment funds, explicit language permitting investment funds to hold debt directly under a loan agreement is always preferable.

Loan agreements loosely modeled on the LMA recommended form also occasionally restrict investors from becoming lenders if they cannot represent at the time of transfer that they are eligible to receive interest payments based on a withholding tax exemption (assuming a withholding tax issue exists). If the investor is an investment fund, it may not be able to obtain the benefit of any double taxation treaty, either due to its or its underlying beneficial investors' place of residence (e.g., Cayman Islands, British Virgin Islands, Jersey, Guernsey, Isle of Man) blocking it from satisfying

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the qualifying lender criteria. The loan agreement may also include other tailored restrictions depending on the jurisdictions involved, posing further barriers for an investor to accede as a direct lender.

Minimum Thresholds

Minimum thresholds can trip up investors when they allocate a traded amount to several funds, or when the investor's seller itself has yet to accede under the loan agreement and does not know the minimum threshold amounts. Assuming an investor is eligible to hold debt as a lender of record under a loan agreement and elects to hold the debt this way, it should ensure that the purchased amount meets any minimum transfer and/or minimum hold requirements. Miscalculations on minimum thresholds will result in the agent refusing a proposed transfer. Occasionally, a loan agreement may also restrict existing lenders by requiring them to transfer pro rata amounts of each facility under such agreement.

There are various reasons for loan agreements to require minimum transfers or holding amounts, including an administrative rationale of trying to limit the size of the lending syndicate and avoiding processing nominal transfers between parties. If the loan agreement contains a minimum transfer threshold but no minimum hold requirements, a quick fix to this problem may be to effect an "over-and-under." As an example, if an investor has purchased GBP1m of debt but the minimum transfer amount is GBP3m, the seller will increase the amount being transferred to GBP4m and the investor will simultaneously transfer GBP3m back to its seller. However, this solution depends on whether the investor's seller has sufficient inventory to implement the strategy and this option may not be suitable if there are minimum hold thresholds in the loan agreement that exceed GBP1m. If this solution is not feasible, an investor may have to increase the traded amount after the trade date, sell back the debt to its seller, or agree to some form of alternative settlement. Ultimately, a failure to meet the requirements under the loan agreement will require the parties to settle the trade by other means, as they will likely be unable to walk away from the trade.

Borrower Consent Requirements

A borrower's refusal to consent to a proposed transfer may impact a proposed lender's strategy, particularly a lender who expects to take on an active role in any restructuring. Investors should be wary of the scope of borrower consent rights, as borrowers may use such rights to block transfers in a loan agreement to investment funds, in order to retain existing relationships with their primary banks that may be viewed as a friendlier counterpart in anticipated restructuring discussions.

Borrower consent requirements became more common during the borrower friendly "covenant light" loans of the 2004 to 2007 credit boom period, effectively allowing a borrower to control the composition of its lending syndicate. The consent requirements commonly include carve-out language requiring consent not be unreasonably withheld. However, what constitutes "reasonable" grounds for the refusal of consent is unclear. The position under English law remains uncertain and English case law does not provide much guidance on the matter.

In 2008, UBS sued 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 breach of contract under a loan agreement following

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the borrower's refusal to consent to a debt transfer. The underlying loan agreement provided that consent by the borrower could not be unreasonably withheld. The proposed transferee was a competitor of Terra Firma, and Terra Firma blocked the transfer on the grounds that it did not want the competitor to have access to its confidential syndicate information. While guidelines from the High Court would have been useful for assessing when an existing lender can be prevented from selling its debt, this case was ultimately settled in private, leaving market participants speculating on what position the court would have taken on this subject.

The standards under New York case law regarding reasonable grounds for withholding consent are similarly undetermined. At best, current New York case law suggests that it may not be unreasonable for a borrower to withhold consent when the buyer is a competitor of the borrower.[16] Under the current LSTA recommended form of loan agreement, the borrower has to affirmatively withhold its consent, as the relevant language deems the borrower to have consented to the transfer if it does not object within five business days.[17] Under loan agreements modeled either on the LSTA or LMA recommended form, the borrower's consent is generally not required after any borrower event of default has occurred and is continuing.

Perfection of Transfer

Even if an investor has received sign-off on a transfer by the agent and has complied with the transfer mechanics for acceding under a loan agreement as a lender of record, if it failed to properly perfect the transfer under the law of the borrower's jurisdiction, it may not be recognized as the legal owner of the debt should it ever have to enforce its rights as a lender. While perfection issues can arise in the context of trading U.S. loans, jurisdictions in Europe may have additional formalities that need to be complied with for a legal transfer to be perfected. Whether these are necessary will depend on a number of factors, including location of the borrower, location of any collateral, governing law of the loan agreement and the form of legal transfer agreed between the parties. Perfection of a legal transfer is separate from any perfection requirements necessary to obtain the benefit of the security package pledged by the borrower, and investors should conduct due diligence on what steps may be required to perfect their transfer in each applicable jurisdiction. Given the severe consequences of potentially not being recognized as the legal owner of the debt, the advice of counsel should be sought to confirm adherence to country-specific procedures.

Failure to perfect a transfer becomes particularly problematic in the context of a borrower's insolvency. Prior to any default or insolvency of the borrower, the governing law of the loan agreement and contractual provisions outlining interest repayments will apply; the agent will record the transfer on its books and make interest distributions to the lending syndicate upon receipt of repayments by the borrower. However, if the borrower enters into insolvency, the laws of the jurisdiction governing the borrower's insolvency will apply. Typically, though not all of the time, this will be the jurisdiction where the borrower is registered.[18] In the context of the borrower's insolvency, an insolvency officer or trustee will seek to ascertain the borrower's total number of existing creditors. The officer or trustee may scrutinize the manner in which a buyer purchased debt on the secondary market to ensure legal ownership was effectively transferred and the buyer has a valid claim in the borrower's estate. For example, the laws of the relevant jurisdiction may require a buyer to take additional steps to perfect a transfer by notifying the borrower of the

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transfer. The creditor's failure to fulfill any of these steps can result in the officer's or trustee's successful challenge to a buyer's legal ownership of the debt.

A successful challenge under such circumstances means that the seller will remain the true legal holder of the debt in the eyes of the third party administering the insolvency and the buyer will not be recognized as having an interest in the borrower's estate. In such circumstances, the buyer will either be required to join proceedings with its seller against the borrower, or seek understanding with the seller that it will pass along any proceeds or distributions received relating to the purchased debt. If the former, the buyer may be faced with resistance as the seller may no longer hold any position in the underlying loan agreement and may not want the burden of getting involved in any insolvency proceedings. Additionally, relationship issues between the borrower and seller may be another reason for resistance from the seller to getting involved. If the latter, the buyer will have to rely on the seller identifying the proceeds relating to the buyer's position and passing these onwards. Not only does this expose the buyer to delays in recouping payment, but this also exposes the buyer to additional credit risk against the seller in the interim. Either situation is unfavorable for the buyer.

Therefore, it is important that once an investor agrees to purchase debt by way of legal transfer, it should verify if it has to take any additional steps to perfect the transfer. In England, if a legal transfer under an English law governed loan agreement is done by novation, no further steps are required for the transfer to be perfected. However, if a legal transfer is done by assignment, the underlying borrower needs to be notified of the transfer regardless of whether or not consent is required.[19] While the relevant loan agreement may include provisions for giving notice, this must be verified on a case-by-case basis. For example, in certain instances where the underlying borrower is French, a transfer between the trade parties may require them to notify the borrower via a bailiff (huissier) for it to be effective against third parties. Where the underlying borrower is Spanish, the parties may need to notarize the transfer document in front of a Spanish notary for it to be elevated to public status and enforceable against third parties.

Conclusion

The above represents certain salient points investors have to consider at the outset of a European distressed debt trade. These points do not represent an exhaustive list of topics but are meant to give investors some background on potential trade diligence required by European secondary loan market participants. Given the complexity of legal issues involved, investors should seek the support of legal counsel to help navigate through the regulatory, tax and credit documentation issues that arise in the context of secondary trading in the European loan markets. The following article, to be published in an upcoming issue of The Hedge Fund Law Report, will discuss some of the more trade-specific issues that arise in the context of a bank debt trade and outline the main points for consideration prior to committing to a binding agreement.

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[1] Current European loan market participants believe one reason that loans remain a smaller portion of new issuance is the lack of investors. It is not possible to raise a retail loan fund in Europe because current regulation does not allow retail investors to invest in loans. See *Trends in Leveraged Finance*, Standard & Poor's Leveraged Matters, Issue 19 (Autumn 2011).
[2] See *Managing the European LBO Refinancing Wall–Some Progress but Material Challenges Remain*, Moody's Investors Service Global Corporate Finance, June 16, 2011.
[3] This includes debt where the underlying borrower is resident in Asia, Africa or Australia. While the Asia Pacific Loan Market Association produces its own documentation to govern secondary debt trades in this region, the documentation is less widespread than the LMA documentation and heavily based on the LMA form.
[4] A full list of the banking activities covered is set out in Annex 1 of the Banking Consolidation Directive: "List of Activities Subject to Mutual Recognition."
[5] See Article L 511-1 of the Monetary and Financial Code.
[6] See Part 1, Section 1 "Definitions", German Banking Act (*Kreditwesengesetz*).
[7] See Legislative Decree 385 of September 1, 1993, as amended in 1997, 2000 and 2007.
[8] This article does not address any issues under U.S. tax law or regulations relating to owning or holding an interest in loans to European borrowers or other debt instruments issued by European issuers. We note, however, that the LMA submitted a comment letter, dated October 4, 2011, to the Internal Revenue Service concerning the impact of the recently enacted Foreign Account Tax Compliance Act (FATCA) on the syndicated credit market. The specific regulations promulgated under FATCA have not yet been finalized, accordingly the ultimate impact of FATCA is still undetermined
[9] Settlement via LMA funded participation results in the existing lender retaining its direct lender position under the loan agreement. Assuming it is receiving interest payments without any withholding tax, it will generally be able to pass onwards the total amount to the investor (i.e., participant), notwithstanding the fact that the investor would not benefit from any withholding tax exemptions if it were the direct lender. Part II of this article will discuss risks relating to English law governed participations.
[10] Pursuant to Section 874(2) of the Income Tax Act 2007. There is no statutory definition of "yearly interest" but it is

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generally understood that if a loan extends beyond a year, the interest will be considered as yearly interest.

[11] Such a direction is only applicable for the beneficial owner in respect of which it is made and cannot be carried over on transfer of that beneficial ownership to another party, even where that party is resident in the same country as the transferor (subject to certain exceptions).

[12] As defined in Rule 501 of Regulation D Rules Governing the Limited Offer and Sale of Securities Without Registration under the Securities Act of 1933 (17 CFR 230.501).

[13] As defined in Section 7(a) of 17 CFR 230.144a.

[14] See clause 24.1 in the LMA Multicurrency Term and Revolving Facilities Agreement, the LMA Multicurrency Term Facility Agreement, the LMA Multicurrency Revolving Facility Agreement, and Clause 23.1 in the LMA Single Currently Term and Revolving Facilities Agreement and the LMA Single Currency Term Facility Agreement, all in effect as of April 8, 2009.

[15] The only relevant requirements were that: (i) it was an entity having a legally recognized form of being; (ii) it carried on business in accordance with the laws of its place of incorporation; and (iii) its business concerned commercial finance.

[16] See *Empresas Cablevison, S.A.B. DE C.V. v. JPMorgan Chase Bank, N.A.*, 680 F. Supp. 2d 625 (S.D.N.Y. 2010) (granting preliminary injunction in favor of borrower (Empresas) enjoining JPMorgan from selling a 90% participation interest with broad information and other rights in a $225 million loan to the affiliate of a competitor of borrower, even though the Empresas had no contractual consent right under the loan agreement), aff'd in part remanded in part, 381 Fed. Appx. 117 (2d Cir. 2010). See "In a Significant Decision for Hedge Funds that Trade Bank Debt, Federal Court Holds that JPMorgan Breached the Implied Covenant of Good Faith and Fair Dealing it Owed to Cablevisión Pursuant to a Credit Agreement When JPMorgan Sold a Loan Participation in Cablevisión's Debt to an Entity Affiliated With Cablevisión's Primary Competitor," The Hedge Fund Law Report, Vol. 3, No. 17 (Apr. 30, 2010).

[17] "The consent of Borrower (such consent not to be unreasonably withheld) shall be required . . . provided that the Borrower shall be deemed to have consented to any such assignment unless it shall object thereto by written notice to the Administrative Agent within [5] Business Days after having received notice thereof."

[18] A borrower resident in a European Union member state will begin insolvency proceedings in its centre of main interest (COMI), pursuant to the EC Regulation on Insolvency Proceedings adopted by the EU Council on May 29, 2000. The aim of the regulation is to simplify the process of dealing with cross-border insolvencies and the regulation states that there can only be one set of main proceedings opened in the state where a borrower has its COMI. The presumption is that the COMI will be where a borrower's registered office is situated, though this can be rebutted in certain instances, the scope of which is beyond this article.

[19] Section 136 of the Law of Property Act 1925.

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The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans

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www.hflawreport.com Volume 4, Number 38 October 27, 2011

Distressed Debt

The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans (Part Two of Two)

By David J. Karp, Roxanne Yanofsky, Erik Schneider and Neil Robson, *Schulte Roth & Zabel LLP*

Although certain distressed debt investors in the European markets would like to believe that senior secured bonds can provide easier and more liquid access to the rights and influence of senior secured lenders, this is not the current reality. Though both bonds and bank debt may have "senior secured" preceding their title, the rights and influence afforded to investors can vary significantly among instruments.[1] While many on the buy side are fighting to bring the senior secured bond structure more in line with bank debt on the premise that a Euro worth of senior secured bonds should be a Euro worth of senior secured bank debt, it remains to be seen when and if this will happen. In most instances, the ability to quickly access the senior secured facility agreement and ancillary documents as well as steer a borrower's proposed restructuring will continue to be driven initially by the senior bank debt lenders. A misstep in trading bank debt while building a portfolio position could therefore shut an investor out from discussions. This makes for a bitter pill to swallow if the investment strategy behind the debt purchase from the outset is to be active in restructuring talks.

Access by an investor to the traditionally "club" world of European bank debt, especially in middle market private situations, can come with challenges. This is especially true for investment funds looking to trade across a borrower's capital structure and seeking liquidity and a quick settlement if things don't go according to plan. In Part 1 of this article series, we examined regulatory and tax[2] issues that may impact an investor's recovery; we identified certain restrictions in the underlying credit documentation that could prohibit an investor from assuming a direct lender of record position; and we discussed perfection issues that may affect a lender's recovery in a borrower insolvency scenario. See "Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans (Part One of Two)," The Hedge Fund Law Report, Vol. 4, No. 37 (Oct. 21, 2011). In this article, Part 2 of the series, we touch upon issues relating to confidential information in the European secondary loan market and trading where a disparity of information exists between syndicate members and restructuring committee members under a credit agreement. Additionally, we discuss the different forms of documentation available for trading bank debt, the various options for purchase of bank debt and the risks associated with each method of settlement.

Investors must appreciate that trade risk exists in the European secondary loan markets. Just as in the U.S. markets that work with a Loan Syndications and Trading Association (LSTA)[3] framework, the Loan Market Association (LMA)[4] operates in accordance with the principle of "a trade is a trade," requiring trading parties to settle the trade once material terms have been agreed. The consequence of this agreement is that decisions made at time of trade will commit an investor to carrying out the transaction even if unfavorable issues come to light after a deal is done. While careful post trade drafting can reduce

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certain trade risks after a deal is struck, the parties should address material trade risks before a trade takes place.

The following key issues should be considered by an investor prior to agreeing a trade:

1. LMA Transparency Guidelines – trading on the basis of Borrower Confidential Information versus Syndicate Confidential Information;
2. Trade Documentation – should the traded debt be documented on par, distressed or claims documentation;
3. Form of Transfer – is legal transfer preferable to an alternative form of settlement;
4. Additional Terms of Trade – are additional modifications to the LMA standard terms and conditions required.

LMA Transparency Guidelines

An increasingly diverse investor base in Europe, combined with greater demand for information transparency, has recently led the LMA to take a position on the conduct of market participants when dealing with confidential information in loan trading transactions. On June 6, 2011, the LMA took the first of what may be a number of steps addressing information disparity between trading parties under any given loan agreement, as well as setting out best practice guidelines for appropriate trading relationships in such circumstances. While the LMA Transparency Guidelines (the "Guidelines")[5] are not legally binding in nature, investors should take note of the LMA recommendations and monitor internal conduct and compliance.

Loan agreements in Europe are by and large private in nature and access to loan information will first require an investor to execute a confidentiality agreement with the borrower or existing lender with permission by the borrower. Once the agreement is finalized, the investor will be provided with the credit documentation as well as a borrower's financial or covenant reports and financial projections as required by the Credit Agreement. The LMA characterizes such information as "Syndicate Confidential Information," as it is made available to the entire lending syndicate subject to each lender undertaking to keep the information it receives confidential. However, and within the lending syndicate, there may be certain lenders who may at some point sit on the steering committee of a borrower preparing for, or in the process of, a restructuring, amendment or refinancing. An investor in this position will be privy to details regarding the proposed restructuring, amendment or refinancing and other sensitive business information not yet made available to the remaining syndicate. The LMA characterizes this type of information as "Borrower Confidential Information."

It is this two-tiered information pyramid that the LMA seeks to address through the release of the Guidelines, which aim to promote equality of information between market participants trading in the secondary loan markets. The LMA Guidelines set out various best practice recommendations for market participants, including: (1) market participants can trade with each other on the basis of Syndicate Confidential Information; and (2) market participants (including the borrower and its related parties) should not trade loans on the basis of Borrower Confidential Information, even where both trading parties have access to the Borrower Confidential Information, unless in certain instances where the transaction would not "adversely affect other members of the syndicate or market."[6] Access to either Borrower or Syndicate Confidential Information should be considered in addition to access by investors to material nonpublic

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information (MNPI), which may be present in both Borrower and Syndicate Confidential Information. Where an investor acquires MNPI regarding a borrower with publicly listed securities, it will be restricted from trading in the securities unless information walls are erected to isolate the MNPI from an investor's other business areas.[7]

In practice, the Guidelines can have significant consequences for investors trading on the LMA platform, as it's common for investors to tactically purchase a borrower's debt with the intention of sitting on its steering committee and influencing any restructuring plan. As a steering committee member will have access to Borrower Confidential Information, a restriction from trading in such circumstances could leave it stuck with a large accumulated debt position which is illiquid in nature until the Borrower Confidential Information has been made available to the rest of the lending syndicate. The process of disseminating information can take a significant amount of time and often be outside the investor's control. The LMA Guidelines recommend that a borrower share Borrower Confidential Information with the rest of the syndicate as soon as possible, but this is not always feasible. A restructuring is a time-consuming and delicate process, requiring ongoing communication and cooperation between the borrower and all participating steering committee members. Until the terms of the actual restructuring are close to being agreed, the borrower will not likely want developments shared with the remainder of its lending syndicate.

Whether this will have an impact on investors wishing to join future borrower steering committees remains to be seen, but critics have threatened the potential for an overall chill in investor participation. Similar to instances where an investor has received MNPI on a borrower and wants to restrict its private and public business practices, the LMA suggests that investors can circumvent the LMA Guidelines by implementing information walls separating persons with Borrower Confidential Information and those with only Syndicate Confidential Information. However, for managers and advisers of investment funds, it may not be possible to set up such a divide without incurring significant administrative costs or impracticalities if most of their trading transactions take place out of small offices with relatively small teams of staff.

It is important to stress that at present time there are no enforcement procedures in place to ensure investors adhere to the Guidelines. The LMA is Europe's trade association for the syndicated loan markets, without punitive powers to penalize market participants who choose not to comply. Additionally, given the fact that bank debt is not listed on any public exchange, many market participants take the view that it remains an unregulated investment and therefore falls outside the scope of the Market Abuse Directive[8] and the jurisdiction of the Financial Services Authority (FSA) in the UK. However, with a greater diversity of investors entering the European secondary loan market, this may generate higher trade volume and liquidity, which may in turn result in bank debt trading in a more "securities-like" fashion and receiving greater regulatory scrutiny as an asset class in the future. Whether the Guidelines can be viewed as a preemptive measure to deter the possibility of FSA interference is subject to speculation. For the time being, the Guidelines do not invoke any specific contractual restrictions and many traders take the view that bank debt for the most part remains outside the scope of regulatory supervision. That being said, there are two important reasons why an investor should not discount the importance of these Guidelines:

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Incorporation of the LMA Transparency Guidelines into Future Trading Documentation

The LMA indicates that it will incorporate the Guidelines into future LMA documentation "where applicable"[9] and the consequent impact on investors will vary depending on the extent of incorporation. For example, if the Guidelines are integrated into the LMA secondary trading documentation as a new representation given by trade parties at time of trade, then trading on the basis of Borrower Confidential Information will become a contractual element of the trade and an investor engaging in improper trading conduct may potentially be sued for damages under a breach of contract by its counterparty.

Damage to the Reputation of the Investor

An investor's continued disregard of the Guidelines could lead to LMA market participants no longer willing to engage in trading relationships with the investor. The LMA is composed of over 476[10] corporate members, so any views it holds are highly persuasive and should be taken into account. Additionally, whereas bank debt may be currently viewed as an unregulated asset, the investor entity (or rather, the manager or adviser of that investment entity where the investor is an investment fund) may be regulated by the FSA, and the persons trading the asset may also be FSA-regulated, so their trading practices as a whole are monitored by the FSA and subject to scrutiny. An investor who completely disregards the Guidelines set forth by the LMA might put itself at risk against a disgruntled counterparty who subsequently voices concern to the FSA over the investor's trading practices. This could prompt the FSA to conduct further investigation into the investor's other trading practices falling within its domain. Being the subject of an FSA investigation can significantly impact on the reputation of an investor, and both criminal and civil charges can be brought by the FSA to the extent any malpractice on a regulated activity is established.

It is also worth nothing that FSA-regulated persons are subject to the FSA Principles for Business[11] and Principle 5 requires that "a firm must observe proper standards of market conduct." Should the Guidelines ever become codified and become the de facto market conduct in the European secondary loans market, the FSA could view a breach of the Guidelines as a breach of FSA rules and take sanctions against the firm (or investment fund) accordingly.

Trade Documentation – Par vs. Distressed vs. Claims

Assuming there are no trading restrictions based on contractual, fiduciary or regulatory requirements, a decision must be made on whether a trade will be conducted on a distressed, claims or par basis. Proceeding with the wrong trade documentation can expose a buyer to downstream litigation risk if it eventually sells its position onwards, or it may create a shortfall in the representations and warranties on the debt suitable for protecting a buyer in a borrower insolvency scenario. Under the LMA regime, the choice of trade documentation is always within the discretion of trading parties and should reflect the economic health of the underlying borrower and risk of its insolvency. Other factors for consideration include current market price, current or anticipated defaults, rating downgrades and negative earnings trends or a spike in CDS levels.

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Faults in the election of proper trade documentation at time of trade can also affect the liquidity of the investor's position in the future. Both the LMA and LSTA recognize that a distressed borrower carries higher underlying credit risk for a buyer than a borrower in good financial condition. Accordingly, a seller will give a buyer additional representations on the status of the asset being sold in a distressed sale. These additional assurances include, for example, representations by the seller that it has not committed any "bad acts" that would affect the buyer's right to receive payments in relation to the purchased bank debt, and that the bank debt being sold is not subject to any impairment or is not otherwise invalid or void.

The LSTA and the LMA, however, implement additional protection measures for the buyer by different means. Under the LSTA, a buyer and seller entering a distressed trade will execute a "Purchase and Sale Agreement for Distressed Trades," the effect of which replaces and supersedes the original trade confirmation and incorporates the additional distressed representations. The LMA instead uses a single set of terms and conditions annexed to the trade confirmation for par, distressed and claims trades, with additional representations and warranties included in the terms and conditions and given by the seller when the trade confirmation indicates that the trade is distressed or being done on a claims basis. The LMA trade confirmation is not superseded by any subsequent agreement and remains the key and active document throughout the life of the trade.

Under the LMA model, representations on the nature and status of the bank debt are given by the seller to the buyer on behalf of itself and all previous owners of the bank debt. This establishes a clear chain of liability and recourse, whereby in the event of a breach of representation, the buyer will seek redress from its immediate seller, even if the seller was not responsible for committing the breach. To the extent the seller is an innocent party, it then seeks recourse from its upstream seller, and the chain continues until the source of the breach is determined. However, this system works only to the extent an investor matches the representations it receives from its seller with the representations it provides its buyer, so that it is afforded protection against exposure for damages against a breach it did not commit. Future liquidity of an investor's bank debt position will be affected when it has purchased debt on par documentation and the debt becomes distressed during the investor's period of ownership. If the investor purchased the debt on par documentation, it will only receive limited representations on the nature of the debt which do not afford it with the same protection as if the debt were purchased on distressed documentation.

If the investor subsequently decides to sell its debt to a market trading the debt on distressed documentation, the investor may be required to provide its buyer with the additional distressed representations incorporated in the LMA standard terms and conditions. In such circumstances there will be a potential mismatch between representations the investor has received from its original seller and those it will be expected to provide its buyer. The investor will want to avoid such a mismatch as this potentially exposes it to additional liability; buyer will have recourse against seller for certain distressed representations that the investor has not received from its upstream seller. Ultimately, the investor may either be stuck with its debt position, or have to make an additional price discount, if it insists, but cannot sell, the debt on a par basis. Alternatively, the investor will have to provide the additional distressed representations to its buyer that it has not received

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from its original seller. In contrast to the LSTA, the LMA does not provide loan market participants with a "shift date" recommending when a particular loan agreement shifts from trading on par to distressed documentation. Therefore, an investor should always try to ensure that the type of documentation used for any sale of debt matches the type of documentation used in the initial upstream purchase.

Form of Transfer: Assignment vs. Novation vs. Funded Participation vs. Legal Transfer Only

The form of purchase elected by the buyer when acquiring the traded debt will impact what recourse it has against the borrower under a loan agreement. While purchase by legal transfer gives a buyer contractual rights against a borrower and is therefore generally the preferred option, it is not always a feasible one. Investors should understand the differences between legal transfer by novation and assignment and which option is more suitable for them. Additionally, investors should understand the difference between settlement via legal transfer and settlement via funded participation and the resulting consequences for each form of purchase.

Settlement by Legal Transfer – Novation vs. Assignment

Typically, and unless restricted (either under the loan agreement or on a regulatory level), the buyer will usually opt for settlement by legal transfer. This allows the buyer to become a direct lender under the loan agreement and affords it the same contractual rights against the borrower as if it were an original lender at the time of primary syndication. In an LMA secondary debt trade, the two most common forms of legal transfer are: (1) transfer by novation (equivalent to an assignment under New York law and most often used in transfer certificates scheduled to LMA loan agreements), and (2) transfer by legal assignment. Most LMA-based loan agreements will allow trade parties to choose between either form of transfer.

Under English law, transfer by legal assignment involves the transfer of rights, but not obligations, i.e., the benefit but not the burden of a contract can be assigned.[12] Under the loan agreement, the existing lender will assign its rights to obtain any interest payments in the underlying loan agreement, and the transfer certificate scheduled to the loan agreement will often contain language stating that the new lender contractually agrees to assume the obligations of the existing lender. The original contract between the borrower and existing lender, however, remains intact. Conversely, legal transfer by novation is the only way an existing lender can effectively "transfer" all its rights and obligations under a loan agreement to a new lender. Novation is a tri-partite agreement replacing the contract between the original lender and borrower and with a new contract between the new lender and borrower. The process of settlement by novation effectively cancels the existing lender's obligations and rights under the loan, while the new lender steps into the existing lender's place with identical new rights and obligations towards the borrower.

As novation provides a clean break for the existing lender and the new lender, it is usually the preferred form of transfer. However, in certain circumstances the creation of any new obligations can impact on the security package granted by the borrower and may cause re-registration requirements by the buyer, giving rise to new deadline periods under English insolvency laws with the ultimate possibility of affecting the priority of a buyer's ranking in an enforcement scenario if re-registration is required but not undertaken within the relevant time frame. Where the underlying loan agreement is

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governed by English law, the borrower is resident in England and the security is held by a security trustee, a transfer by novation will likely be used. The use of a security trustee in England may circumvent any security issues by being the registered legal holder of the security, with lenders entering into a subsequent security trustee agreement, allowing them to accede and resign over the course of the loan as debt positions exchange hands.

However, depending on how the underlying security for the loan has been structured, and if the borrower or corresponding security is located in a jurisdiction outside of England, legal assignment may be favored instead. Structuring the security so that it is held by a security trustee may not be efficient outside of England as the concept of a trust is not recognized in all other European jurisdictions. A legal assignment is a good alternative in such circumstances as it does not sever the existing lender's contract with the borrower, and any transfer of debt will have the corresponding security accompanied with it. The downside, however, is that certain criteria will need to be fulfilled in order to ensure that a legal assignment is properly effected. One such requirement is that the assignor transfers to the assignee its entire debt position. This is a big obstacle to overcome as most debt trades do not involve transfers of entire positions and failure to comply with such criteria will result in a legal assignment being treated as an equitable assignment only. The immediate consequence of this demotion is that in the event of a borrower becoming insolvent, as a matter of procedure the equitable assignee would have to join the assignor in any proceedings against the borrower. Nonetheless, this may be the most desirable option available for a buyer if novation is not possible.

Settlement by Participation

The LMA's mandatory settlement provisions mean that if a trade cannot settle by novation or assignment the LMA contemplates an automatic "fall-back" to settlement via funded participation. If buyer and seller pursue settlement by funded participation, care should be given to the way the funded participation is structured and the risks involved with such an arrangement.[13]

The LMA form of funded participation governed by English law contemplates a debtor/creditor relationship between seller and buyer, with seller ("grantor") agreeing to pass along to buyer ("participant") the economic equivalent of any payments it receives from the borrower under the loan agreement. The participant has no contractual relationship with the underlying borrower, and no recourse against the borrower to the extent the borrower defaults on any of its loan obligations. Because the participant has no legal interest in the payments, the participant will also be exposed to the credit risk of the grantor.[14] To the extent it becomes insolvent, the participant will only have an unsecured claim against the grantor under the funded participation and cannot claim any proprietary interest or entitlement in the underlying loan.[15]

In contrast, the LSTA form of funded participation governed by New York law is structured as a so-called "true participation" between a buyer and a seller. A "true participation" is arranged to give the buyer an ownership interest in the actual proceeds paid by a borrower to the seller. Whether a participation constitutes a "true participation" under New York law is a fact-based analysis.[16] The LSTA form intends to assign the participant all of the

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rights of grantor to payment under the loan agreement, giving it an actual ownership interest in the underlying payment stream.[17] In the event the grantor becomes subject to insolvency proceedings, these payments are intended to be isolated from its insolvency estate, resulting in more limited counterparty credit risk for a participant under a "true participation."

The magnitude of effect between an LMA versus LSTA form of participation was highlighted recently in the bankruptcy proceedings of Lehman Commercial Paper Inc. (LCPI), a subsidiary of Lehman Brothers Holdings Inc. (LBHI). Several investment funds had entered into LMA participation agreements with LCPI in respect of various loan agreements, and the funds elevated their participations after LBHI filed for bankruptcy on September 15, 2008, but before LCPI filed for bankruptcy on October 5, 2008. As a result of the elevations, the funds took on direct lender of record positions and began obtaining the benefit of principal and interest repayments under the loan agreements from the relevant borrowers. LCPI subsequently challenged these elevations as avoidable preferential transfers under the Bankruptcy Code. LCPI argued in its complaints that as a result of the elevations, the funds, as newly elevated lenders of record, were receiving more than they would receive in a Chapter 7 liquidation and any principal or interest payments should be clawed back on that basis. LCPI's argument stated that due to the terms of the LMA participation agreements, the funds and LCPI had a only debtor/creditor relationship and therefore the funds should rank as unsecured creditors in LCPI's estate. The proceedings are currently stayed until January 20, 2012 so the ultimate decision on how these elevations will be treated remains to be seen. For the time being, however, these funds remain in limbo.[18] In contrast to the funds' situation, other parties who elevated their LSTA participation with LCPI were able to do so pursuant to an order by the Lehman Brothers bankruptcy court and elevations of "true participations" have not been challenged to date.[19]

Given the benefits of mitigating credit risk, the LSTA structure may seem more desirable. However, underlying the dichotomy between an LSTA "true participation" and the LMA participation structure is a fundamental difference in interests between a grantor and a participant. One the one hand, the grantor has already sold its economic risk in the asset to the participant as of the trade date and so may be less inclined to spend time and money amending the documentation required to effect the sale, and generally preferring the documentation that allows it to move the assets off its balance sheet under applicable accounting rules. On the other hand, the participant will seek to minimize its credit risk vis-à-vis the grantor and minimize any tax impact resulting from its form of ownership.[20] The following are just a couple of the reasons why, for the most part, parties to LMA trades do not use the LSTA structure.

<u>Withholding tax implications for the participant</u>. Assuming participant and grantor agree to settle an LMA trade using a modified funded participation to account for a "true participation" of interest, there may be tax implications for a participant and a withholding tax may apply. If the grantor is based in another jurisdiction where it is receiving interest payments under the loan agreement gross by virtue of a double taxation treaty, it may no longer be able to obtain the benefit of this treaty if it cannot represent it is the beneficial owner of the asset (which it will be unable to do, having participated beneficial ownership of the asset to the participant). This change in status may mean

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that the grantor will be withheld against on future interest payments made and will pass along only the net interest to the participant. Under the recommended form of LMA participation, there is no gross-up provision requiring the grantor to gross-up any withholding taxes paid in respect of the asset. Therefore, and in such circumstances, not only will the participant be exposed to double counterparty credit risk (vis-à-vis the borrower and grantor) but it will also suffer from a withholding tax on interest payments made in relation to the participated asset. The participant should therefore verify in advance the basis upon which the grantor receives interest payments without withholding tax and the impact of trade settlement by "true participation" before agreeing to any settlement via this way.

LMA funded participation is the contemplated fall-back option in an LMA trade transaction. If a trade is conducted on an LMA basis, settlement by LMA funded participation is the fall-back or alternative form of settlement mechanism in the event settlement by legal transfer cannot take place. The LMA contemplates legal transfer as the desired form of settlement and assumes that neither party prefers to settle via funded participation. Therefore, assuming funded participation is elected at time of trade or triggered if legal transfer cannot be effected, the grantor will likely prefer to settle the trade on the LMA's recommended form of document and will not want to undertake the time delays and possible additional costs involved in negotiating and drafting the form of document preferred by the participant to achieve a "true participation."

Any Additional Trade-Specific Terms

The LMA secondary-trading documentation does not and cannot contemplate every possible trade scenario. Each borrower and loan agreement contains distinctive features that need to be discussed by the trade parties at time of trade and addressed in the resulting trade confirmation. If an investor trades on LMA documentation without considering the specifics of a transaction, it may significantly impact economic return or hinder future liquidity of the purchased debt. It is only by stepping back and taking a more holistic view of the transaction that an investor will be best placed in determining what terms should be incorporated when negotiating a trade.

Commonly overlooked issues can range from contractual restrictions in a credit agreement to overall market consensus on how an asset is currently being traded. For example, investors will regularly fail to address the subject of payment of transfer fees for a debt transfer under a loan agreement. While a GBP1,500-GBP3,000 price tag per transfer may not seem off-putting at the outset, it becomes a more painful fee to disburse when the investor subsequently allocates the trade between several related funds and its trade counterparty refuses to contribute more than half of one fee in total. On a broader level, the practice of trading Icelandic claims on modified LMA terms has become so prevalent that new investors seeking to enter this market may be disadvantaged buying an Icelandic claim on a straightforward LMA basis. Assuming the investor then intends to sell the claim prior to a distribution, a prospective buyer will likely request the additional terms included; this will put the investor in a position where it either has to provide the additional terms it did not receive in its buy-in, or refuse to sell the claim unless on an LMA basis, thereby restricting the pool of buyers available.

Conclusion

While the above topics are not exhaustive in nature, they are meant to streamline an investor's focus and provide specific insight on certain key trading issues that could impact a

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trade. Employing vigilance in reviewing these issues will help in the implementation of an effective investment strategy and minimize downside and liquidity risk as well as prevent delays in settlement of a trade. Given the complexity of issues involved, investors should seek the support of legal counsel in tackling any trade specific matters arising in the context of secondary loan trading in Europe.

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[1] European Leverage Finance Buyside Forum letter dated March 21, 2011, published by International Financial Law review suggesting that, among other things, the Senior Facility Agreement should be disclosed by issuers and that upon an event of restructuring or insolvency senior facility agreement lenders and senior secured bondholders should vote as a single class with respect to enforcement rights.
[2] As previously noted in Part I, this article does not discuss any U.S. tax issues (including issues related, but not limited to, possible loan origination, workouts, distressed investing and withholding taxes) that may arise in the context of investing in the loans described herein.
[3] See http://www.lsta.org/.
[4] See http://www.loan-market-assoc.com/.
[5] See LMA Transparency Guidelines, set out in the LMA website: www.loan-market-assoc.com.

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[6] The LMA has not provided clarification on when a trade would "adversely affect the syndicate or the market," though one might speculate this is meant to catch any transaction that could significantly affect the price of the debt. For example, if an investor sitting on a borrower's steering committee offloads a big debt position at a heavily discounted price to another investor sitting on the same steering committee, and resulting in a significant overall price fall in the debt or a significant change in trajectory of the company's restructuring plans, there could be a breach of the Guidelines if the selling investor did not properly account for the adverse affect this sale would have on the lending syndicate or market.

[7] The treatment of MNPI has been discussed by the LMA in previous papers addressed: "Dealing with confidential and price-sensitive information" and "Private and Inside Information in the Loan Market," both of which are available on the LMA website. See "Use by Hedge Fund Managers of Restricted Lists, Watch Lists and Ethical Walls to Prevent Insider Trading Violations," The Hedge Fund Law Report, Vol. 4, No. 37 (Oct. 21, 2011).

[8] 2003/6/EC Directive of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse) regulating other traded instruments such as publicly listed bonds and shares in the European Union.

[9] See LMA Transparency Guidelines, set out in the LMA website.

[10] Reported during the 4th Annual LMA Syndicated Loans Conference on September 15, 2011.

[11] Available at: http://fsahandbook.info/FSA/html/handbook/PRIN/2/1.

[12] S.136(1) of the Law of Property Act 1925 outlines the requirements to effect transfer by legal assignment.

[13] Trade parties can also elect to bypass settlement by funded participation by agreeing to settlement by "legal transfer only" at time of trade. Settlement by "legal transfer only" will involve some alternative form of settlement providing buyer and seller with the economic equivalent of the agreed-upon trade but the LMA does not go into detail as to the alternative forms. This would likely involve the trade parties entering into a form of swap arrangement.

[14] This characterization of the relationship in participation agreements governed by English law has been upheld by English courts. See, e.g., *Lloyds TSB Bank plc v. Clarke (Liquidator of Socimer Int'l Bank ltd)*, [2002] UKPC 27 (affirming a decision on appeal from Court of Appeal of the Bahamas by holding that a participant in a participation agreement governed by English law (which incidentally was titled "sub-participation agreement") did not have a proprietary interest in the underlying bonds or their proceeds, after first determining that, unlike "assignment" or "trust," the term "sub-participation agreement" is not a legal term of art, so that the legal rights and duties of the parties were a matter of construction of the agreement. The court found that the agreement showed no intention of the parties that the proceeds received from the underlying bonds were to be the source of payment, rather the agreement stated that the relationship was a "debtor-creditor relationship" and that the participant "shall have no right of ownership in the Subject Notes").

[15] The LMA produced a paper in January 2010 called "Funded Participations – Mitigation of Grantor Credit Risk" which provides trade parties with possible steps on how to mitigate seller credit risk. However, the paper explicitly states that its aim is not to prescribe mitigation techniques for members to adopt or make recommendations as to whether a technique is appropriate in any particular transaction.

[16] In general, "true participations" share the following

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characteristics: (1) the participation sets forth the parties' intention to effect a sale of a property interest; (2) the seller does not guarantee repayment or otherwise provide recourse inconsistent with a sale; (3) the participation and the underlying obligation have the same duration; (4) the participant receives no greater return than that provided by the underlying loan; (5) the seller holds the evidence and proceeds of underlying indebtedness for the benefit of the purchaser; (6) the seller cannot commingle loan proceeds for any substantial length of time; and (7) if the seller (or its affiliate) acts as servicer, it does not exercise unlimited discretion in performing such services.

[17] The Standard Terms for Participation Agreements for Distressed Trades promulgated by the LSTA provide that when seller of a participation receives any type of payment from the participated loan's obligor, then, among other things, such seller "shall accept . . . such Distribution for the account and sole benefit of Buyer, . . . have no equitable or beneficial interest in such Distribution and . . . deliver such Distribution . . . to Buyer." Section 8.2 LSTA Standard Terms and Conditions for Participation Agreements for Distressed Trades, published October 24, 2007.

[18] The adversary proceedings (Adv. Case Nos. 10-03830, 10-03831, 10-03832 & 10-03833) were stayed for a period of nine months pursuant to the Order signed on October 20, 2010 Staying Avoidance Actions and Granting Certain Related Relief [Doc No. 12199, Case No. 08-13555]. The stay was extended for six months until January 20, 2012 pursuant to the Order signed on June 16, 2011 Extending the Stay of Avoidance Actions and Granting Certain Related Relief Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rule 7004(a)(1) [Case No. 08-13555; Docket No. 17763].

[19] See Order Pursuant to Sections 105(a), 363(b), and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing Debtor to (A) Continue to Utilize its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations [Docket No. 11, Case No. 08-13900]. (The order expressly stated that its entry did not "waive the right to subsequently argue that such participation or sub-participations are not true participations and that any cash or securities distributed to holders of such participations or sub-participations was property of the estate.")

[20] For a more detailed assessment of tax implications resulting for holding debt in a lender of record capacity, see "Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans (Part One of Two)," The Hedge Fund Law Report, Vol. 4, No. 37 (Oct. 21, 2011).

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European Insolvency Claims Trading: Is Iceland the Paradigm?

KEY POINTS

- Claims trading provides an opportunity for creditors to exit an insolvency proceeding and monetise their claim and for claims purchasers to invest in a distressed asset.
- Purchasers should conduct due diligence on the claim for recovery, notional amount and counterparty credit risk.
- Notional amount risk is often heavily negotiated as it can have a significant impact on a purchaser's investment success or failure.
- To date, and for the most part, European claims are documented on either the Loan Market Association (LMA's) claims documentation, or bespoke documentation with US-style risk allocation provisions.
- The documentation used in future claims markets will likely depend on the nature and form of the contracts giving rise to the claims.

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European insolvency claims trading: is Iceland the paradigm?

This article discusses how the secondary markets for claims against the Icelandic Banks and Lehman Brothers International (Europe) emerged, the legal documentation employed by investors in each market when buying and selling a claim, and the course of the future European secondary claims markets in the next few years.

In recent years, the bulk of the European secondary claims market volume has been attributable to claims against failed banks. This began with the administration of Lehman Brothers International (Europe) ('LBIE') in September 2008, but exploded in size following the collapse of the three biggest banks in Iceland in early October 2008: Kaupthing Banki hf, Glitnir Banki hf, and Landsbanki hf ('Icelandic Banks').[1] While the demise of both LBIE and the Icelandic Banks occurred in Europe, the subsequent markets and procedures established for trading claims against LBIE and the Icelandic Banks has differed to a significant degree.

In part, these different claims trading procedures are due to the nature of the insolvencies; the collapse of the Icelandic Banks, while affecting creditors globally, was isolated to banks formed in Iceland, whereas the administration of LBIE was just one limb of the bigger overall failure of Lehman Brothers Holdings Inc ('LBHI'). However, the key factor in determining market trajectories is the nature of the underlying contracts giving rise to the claims being traded; the defining features of an Icelandic claim being largely dissimilar to the features that characterise an LBIE claim. This is the root of the divergence in how the markets have developed over the past three years and the legal documentation utilised by investors when trading claims in the secondary markets.

Understanding this distinction is even more important as many market participants expect sovereign debt restructurings or defaults to negatively impact the solvency of other banks, financial institutions and companies across Europe. Additionally, many leveraged loan deals that were syndicated during the 2004-2007 high liquidity period are set to mature in the next couple of years. S&P estimates that approximately $4,000bn European investment- and junk-grade corporate loans and debt instruments will mature between mid-2011 and the end of 2015.[2] Given the credit quality of many of the companies in distress, refinancing options, or amending and extending an existing loan agreement, may not be available. Consequently, such companies may find themselves in formal insolvency proceedings.

This article will discuss how the secondary markets for claims against both the Icelandic Banks and LBIE emerged, and the legal documentation employed by investors in each market when buying and selling a claim. It is against this backdrop that investors will be able to assess the course of the future European secondary claims markets and the basis of how claims will trade in insolvencies that surface over the next few years.

WHY DO CREDITORS AND INVESTORS TRADE INSOLVENCY CLAIMS?

The secondary claims market allows creditors to sell and monetise their claims against an insolvent party instead of waiting months or even years for a distribution in the formal insolvency proceedings to take place. Investors buy claims from creditors either expecting to receive a higher distribution in the insolvency estate than what they originally paid for the claim, or with the aim of selling the claim onwards to a third party at a higher price than what they bought the claim for. Claim purchasers are active in many smaller and lesser-known insolvencies, in addition to larger and well-known bankrupt entities such as LBHI and its affiliates, LyondellBasell and Nortel Networks.

There are at least three types of risk investors seeking to buy claims in the secondary claims market should account for: recovery risk (ie, the percentage of a claim a creditor expects to receive as a distribution in the insolvency proceedings of the third party and the timing of that distribution), notional amount risk (ie, the face amount of the claim and whether that amount will be reduced in the insolvency proceedings of the third party) and counterparty credit risk (ie, if a purchaser of a claim has recourse against its seller, will the seller be able to make good on the monetary damages or indemnification it owes the purchaser). To a certain extent, these types of risk can be mitigated by the purchaser conducting extensive due diligence on the claim before agreeing to a purchase. This will include identifying the selling counterparty and determining whether the purchaser is comfortable transacting with it. Recovery risk is principally addressed in the purchaser's calculation of the price to be paid for the claim.

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Notional amount risk, however, and how a purchaser and seller allocate this risk among themselves, is often the most heavily negotiated aspect of the transaction documents. Notional amount risk is the risk that the insolvent company or other party with legal standing challenges the validity of the claim or objects to the calculation of the claim amount. If successful, a reduction in the notional amount of the claim will result in a lower recovery for the claimholder because it reduces its share in any distribution. In most cases, diligence on the claim can only minimise, but not eliminate, notional amount risk. Therefore, it is generally allocated and addressed between the purchaser and seller of a claim in the negotiated agreement documenting the sale of the claim.

"The LMA claims documentation was ... able to accommodate the secondary market for trading Icelandic claims because of the actual composition and characteristics of the claims being traded."

THE ICELANDIC EXPERIENCE AND UTILISATION OF LOAN MARKET ASSOCIATION ('LMA') DOCUMENTATION

When the Icelandic Banks went into receivership in early October 2008, investors were quick to spot a potentially lucrative trading opportunity, and a secondary market for the trading of Icelandic claims emerged. Winding-up committees were appointed by the District Court of Reykjavik to oversee the claim filings and recognition process of each of the Icelandic Banks. The Icelandic Banks each also released formal claim transfer documentation, all very similar in substance, as a way of providing notice of any transfer and for monitoring the current claimholders. This formal documentation, however, did not set out the terms and conditions of a transfer and primarily specified details of the claim and amounts being transferred between purchaser and seller.

To address the substantive terms and conditions of a sale, there was initially debate in the market of how to best document the economic agreement between a purchaser and seller of an Icelandic claim. The market consensus eventually swayed towards utilising LMA claims documentation, which is governed by English law. Both claim sellers and purchasers accepted a mismatch between the receivership of the Icelandic Banks under Icelandic law and the English law documentation of the contractual agreement for the sale of a claim. The form and structure of the LMA was familiar to investors with experience in the European secondary markets and many of the original claimholders who were located in Europe and were looking to sell their claims.

The LMA claims documentation was, in large part, able to accommodate the secondary market for trading Icelandic claims because of the actual composition and characteristics of the claims being traded. The most heavily traded claims against the Icelandic Banks related to bank debt, bonds or notes and these assets were issued through a common underlying loan agreement or indenture. These formal documents included terms and conditions governing the instrument and providing a relatively clear method of calculating principal amounts owed to a creditor once the Icelandic Banks could not meet their debt repayment obligations (although the methodology for calculating interest varied between claimholders). Claimholders faced a relatively lower level of notional amount risk on the principal amount of their underlying instrument when compared to individual vendors or holders of corporate claims against the Icelandic Banks, whose claims may not always be in a form where a secondary purchaser could properly ascertain validity.

An advantage of trading Icelandic claims on LMA claims documentation is that it provides a platform that can support a liquid market, incorporating certain terms and conditions for the sale of a claim which a purchaser will receive when purchasing a claim and also provide to a third party should it decide to sell the claim onwards. These terms and conditions include specific representations and warranties given by a seller to a purchaser on the claim sold. Arguably the most important representation given under the LMA claims documentation is the no 'bad acts' representation. This is given to protect the purchaser against any conduct or omission by the seller or any previous claimholder that would affect the purchaser's right to receive distributions in respect of the purchased claim. A 'bad act' could include a situation where a seller is the only entity within a syndicate that has not brought proceedings against a third party and, therefore, misses any earnings shared by the syndicate as a result, or any other situation that results in a reduced recovery by virtue of the seller's act or failure to act.

However, tailoring the LMA claims documentation to suit the winding-up proceedings in Iceland was complicated. The documents had to account for unique features of the Icelandic secondary market and the LMA representations and warranties were supplemented where applicable. Questions regarding possible withholding tax implications on capital gains a seller made on a claim sale, the different creditor classes and priority treatment of certain types of Icelandic claims, and instances where duplicative proof of debt filings under an indenture were made by individual bondholders and an appointed trustee were all addressed through additional modifications to representations given by a seller to a purchaser in the agreed LMA claims documentation.

Another significant challenge investors faced was reconciling the mismatch between the design of the LMA claims documentation *vis-à-vis* its use by market participants. The LMA is a trade association that produces recommended documentation for bank debt, and its template claims documentation is geared towards English law-governed loan-related claims.

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Modifications had to be made to account for the fact that the proceedings were taking place in Iceland. As bond and note instruments represented a significant portion of claims against the Icelandic Banks, heavy modifications also had to be made to the form to accommodate this different asset.

THE LBIE EXPERIENCE AND UTILISING US BANKRUPTCY CLAIMS TRADING STRUCTURES

LBIE went into administration on 15 September 2008, the same day its ultimate corporate parent, LBHI, filed for chapter 11 bankruptcy protection in the US. LBIE was LBHI's main broker-dealer in Europe and provided investment banking and prime brokerage services to its clients. Together with their affiliates, LBHI and LBIE comprised one of the four largest investment banks in the world and their bankruptcy proceedings, to date, have been the largest in history. Prior to its administration, LBIE was also a participant in the capital markets and engaged in activities such as secondary trading, financing, origination and securitisation. LBIE sold, and was a counterparty to, a broad range of derivative, secured financing, and structured investments and instruments.

In addition to claims for customer assets and monies held by LBIE, many creditors brought unsecured claims against LBIE for amounts they alleged LBIE owed under terminated swap or derivatives contracts, terminated repurchase agreements, terminated prime brokerage agreements, and other similar types of agreements. These types of claims primarily arose from specific bilateral contracts between LBIE and a creditor. To determine an amount owed, and unlike a central written agreement specifying a prescribed formula (as seen in many instances with bank debt and bond claims against the Icelandic Banks), each creditor had to calculate the face amount of its claim based on the terms of the specific underlying contract.

Calculating a claim's notional amount depended on numerous factors. In the context of a derivative contract, a party's payment obligations were based on, for example, the valuation of another third-party obligation, the relative movement of interest rates or the change in value of another asset. In the context of a repurchase agreement or prime brokerage agreement, amounts owed between parties depended on the valuation of assets (such as securities, loans, or other financial instruments) at a given point of time. To make matters more complicated, the existing market conditions at the time of the commencement of LBIE's administration were such that valuations fluctuated considerably on a daily basis. Depending on the date a creditor deemed to be the 'termination date' of a contract, the claim amount could vary considerably as well. Consequentially, most LBIE claims are separate and distinct from one another and the notional amount of a creditor's claim against LBIE may be subject to interpretation and potentially challenged by LBIE, its administrators or other parties with legal standing to do so.

In light of the above and in contrast to the majority of claims against the Icelandic Banks, LBIE claims generally trade on bespoke transfer documentation incorporating terms that address the particular issues of a claim. This structure is akin to the structure used to trade bankruptcy claims in the US. While there is no US standard market documentation for secondary claim purchases, common features across US claims trading documentation have emerged to address existing notional amount risk factors. These features include extensive representations and warranties on the claim and underlying contract documentation, direct recourse provisions through the concept of 'put-rights' or indemnification in the event of a claim impairment, or agreement between the parties that a purchaser hold back payment of a portion of the purchase price under certain conditions.

In supplement to a purchaser's due diligence of a claim, a seller may provide a purchaser representations and warranties against the risk of any subsequent reduction in a claim's face amount. These cover some of the most common scenarios where the notional amount of a claim may be reduced, and generally include representations that a seller has filed a proof of debt in accordance with filing deadlines and procedural requirements, the claim is enforceable against the bankrupt party in the full claim amount, the seller is not subject to any litigation by the bankrupt party, the claim is not subject to any offsets or reductions, and neither the seller nor any previous claimholder relating to that claim has engaged in any 'bad acts' that could result in the claim being subjected to equitable subordination. However, and depending on the bargaining power between a seller and its purchaser, these representations and warranties are sometimes qualified by the seller's knowledge of the facts. In such circumstances, the risk of a claim impairment resulting from reasons that are beyond the seller's knowledge will remain with the purchaser.

In addition to the representations and warranties provided by a seller, the buyer may also negotiate additional measures of recourse against its seller in the event of a reduction in the claim amount or other impairment on the claim affecting a purchaser's rights to receive a distribution. These measures of recourse are typically implemented through the inclusion of an indemnification or put-right provision given by a seller to its purchaser in the agreement documenting the purchase and sale of a claim. An indemnification provision allows a purchaser to recoup any financial loss suffered as a result of a breach of a seller's representation or warranty. A put-right gives the purchaser a right to require the seller to re-purchase a portion or the entire amount of the claim from the purchaser at the original purchase price plus interest. This right is often triggered where there is a reduction in the claim's notional amount or the claim is otherwise impaired. The point at which

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this right arises (for example, as soon as the claim is challenged or only after a final determination on the claim's notional amount is established) is a matter for negotiation between the seller and purchaser.

In either circumstance where a put-right or indemnification provision is agreed, a purchaser must factor in its exposure to the credit risk of its seller. A purchaser who agrees to purchase a claim on documents with either type of recourse provision included should recognise that either avenue of recourse is only of value to the extent its seller has the ability to provide compensation when the provision is exercised. Where a seller is insolvent at the time, even the most carefully crafted provision may not enable a purchaser to recover loss suffered through the impairment of its claim.

Finally, the purchaser may agree with its seller that it will hold back payment of part of the purchase price until a claim is allowed in the full amount by the bankruptcy court or administrator. Only once the claim is allowed will the purchaser pay its seller the remaining amount. Where the claim is allowed, but only for a lesser amount, the holdback payment is reduced in the corresponding percentage. The inclusion of a holdback provision may be useful where the seller and purchaser cannot agree on the allocation of notional amount risk between them, or when the purchaser is doubtful of the creditworthiness of its seller. If the latter, then the purchaser is protected to the extent of the holdback in the event there is a reduction in the claim amount and the seller is unable to provide recourse to its purchaser because it itself has entered into insolvency proceedings.

FUTURE CLAIMS MARKETS WILL UTILISE LMA OR US-STYLE DOCUMENTATION WHERE APPROPRIATE

The Icelandic and LBIE experiences are two distinct examples of markets and procedures that were established to deal with the secondary trading opportunities that emerged. Investors looking for future claims trading opportunities must now ask themselves what course the market will take when the next wave of corporate and bank insolvencies occur. The answer is not straightforward or clear cut.

Investors will have to scrutinise the nature of the insolvency, the country specific legal regime, and components of the underlying claims documentation that arise as a result in order to assess the best documentation fit. Preference may lean towards using LMA claims documentation to trade claims arising from syndicated bank debt of a large European borrower. The experience with Iceland demonstrates that, in certain circumstances, even claims based on assets sharing common features with bank debt (such as bonds) can utilise the LMA claims documentation. In addition, the possibility for using LMA claims documentation may also exist for claims arising from other types of bilateral or unsyndicated loans.

> "Investors ... must now ask themselves what course the market will take when the next wave of corporate and bank insolvencies occur."

In contrast, US-style documentation may be a more appropriate fit where a creditor's claim is based on individually negotiated contracts or service agreements. These claims could arise from all types of bilateral relationships between a creditor and the insolvent company including informal documentation, such as invoices or receipts, or claims arising from derivative and other structured investment products (ie, forward supply, futures and derivative contracts). The latter type of claims would likely play a large role in any large bank failure, but may also be significant in the insolvency of a corporate entity as many companies hedge any commodity and foreign exchange risk exposure using these types of contracts. While these claims may be based on agreements that are formally documented between the creditor and insolvent party, they are nonetheless based on highly negotiated and individualised terms, and the method and mechanism that a creditor uses to determine the claim's notional amount may be subject to dispute or challenge. Accordingly, when buying these types of claims, US-style documentation may be more appropriate.

Depending on the size of the company or bank insolvency, and the subsequent size of the secondary market that develops, an investor may not always have the ability to utilise its preferred form of documentation. A large-scale insolvency and liquid secondary trading market will likely include sophisticated sellers (for example, financial institutions or investment funds) that will push for the documentation that best protects their interest rather than the purchaser's. This may or may not include LMA claims documentation or other US-style bankruptcy documentation. Where the insolvency relates to a smaller and foreign European entity, its domestic creditors might insist on using documentation governed by local law instead. Generally, additional thought should be given where the law governing the contract documentation agreeing to the sale of a claim does not match the jurisdiction of the insolvency proceedings of the insolvent party. In such circumstances, investors will not only have to grapple with a foreign jurisdiction's insolvency regime, but will also have to become comfortable that the contractual terms agreed under the contract will be enforceable in the relevant courts to the extent there is ever a dispute as to the terms of a sale. ■

1 Other smaller Icelandic banks, including Straumur Burdaras Investment Bank hf. and Icebank hf, also failed, but the market for their claims was significantly smaller. Icebank hf had a much smaller asset base and the Straumur Burdaras Investment Bank hf. effected a successful composition agreement with its creditors in 2010.

2 *Financial Times*, 'Funding gap: Companies may founder on wall of maturities', published 22 September 2011, available at: www.ft.com/cms/s/0/1445faa4-e2b5-11e0-897a-00144feabdc0.html#ixzz1c5o3nYJO.

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