Schulte Roth&Zabel

Distressed Debt & Claims Trading Developments

summer 2011

Debt Trading Clarity From the Authoritative Voice of the European Market

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

*see **Key Changes to Secondary Trading Documentation** on page 6*

Roxanne Yanofsky Joins SRZ

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

Inside:

Debt Traders Settling Post-Reorganization Equity

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

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

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

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

Possible Causes of Delay

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

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

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

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

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

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

Bankruptcy Claims Trading Orders: Who is Watching?

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

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

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

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

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

Debt Traders Settling Post-Reorganization Equity

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

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

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

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

Pushing Unresponsive Counterparties to Settle

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

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

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

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Bankruptcy Claims Trading Orders

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

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

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

Pushing Unresponsive Counterparties to Settle

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Key features of the proposed Distressed BISO continued:

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

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

Bankruptcy Claims Trading Orders

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

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

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

[4] *Id.* at 19.

Key Changes to Secondary Trading Documentation

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

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

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

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