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.

Schulte Roth&Zabel
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000 | +44 (0) 20 7081 8010 fax
London | New York | Washington DC | www.srz.com

Authors David J Karp, Erik Schneider and Roxanne Yanofsky

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.

Schulte Roth&Zabel

Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000 | +44 (0) 20 7081 8010 fax
London | New York | Washington DC | **www.srz.com**

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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Schulte Roth & Zabel International LLP
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+44 (0) 20 7081 8000 | +44 (0) 20 7081 8010 fax
London | New York | Washington DC | www.srz.com

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.

> "LBIE claims generally trade on bespoke transfer documentation incorporating terms that address the particular issues of a claim."

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

Schulte Roth&Zabel
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row, London W1S 3PR
+44 (0) 20 7081 8000 | +44 (0) 20 7081 8010 fax
London | New York | Washington DC | www.srz.com

Biog box
David J Karp is special counsel in the New York and London offices of Schulte Roth & Zabel LLP. Email: david.karp@srz.com
Erik Schneider is an associate in the New York office of Schulte Roth & Zabel LLP. Email: erik.schneider@srz.com
Roxanne Yanofsky is an associate in the London office of Schulte Roth & Zabel LLP. Email: roxanne.yanofsky@srz.com

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.

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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.