The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

Schulte Roth&Zabel

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

©2011 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 4, Number 38 October 27, 2011

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

©2011 The Hedge Fund Law Report. All rights reserved.

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

Schulte Roth&Zabel

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

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:

©2011 The Hedge Fund Law Report. All rights reserved.

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

Schulte Roth & Zabel

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

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.

©2011 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

Schulte Roth & Zabel

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

©2011 The Hedge Fund Law Report. All rights reserved.

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

©2011 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 4, Number 38 October 27, 2011

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

©2011 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 4, Number 38 October 27, 2011

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.

Withholding tax implications for the participant. 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

©2011 The Hedge Fund Law Report. All rights reserved.

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

©2011 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth & Zabel
www.hflawreport.com Volume 4, Number 38 October 27, 2011

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.

David J. Karp is a special counsel 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 and Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters.

Roxanne Yanofsky is an associate in the London office of Schulte Roth & Zabel LLP, where her practice primarily focuses on the secondary loan markets and providing advice on the legal issues relating to the purchase and sale of distressed assets, including trade claims. She advises on all aspects of debt and claims trade transactions, including the review and analysis of syndicate loan documentation, security packages, transferability restrictions and confidentiality and disclosure requirements. Roxanne routinely represents hedge funds, banks and other financial institutions in the drafting and negotiation of secondary trading documentation under the Loan Market Association regime, and is frequently involved in cross-border transactions throughout Europe, the U.S. and Asia.

Erik Schneider is an associate in the New York office of Schulte Roth & Zabel LLP, where his practice focuses on representing investment funds as buyers and sellers of distressed loans, bankruptcy claims and other debt products, and negotiating and documenting all aspects of distressed bank debt trades. Erik has represented several investment funds in connection with buying into, subscribing to and receiving proceeds from various rights offerings under plans of reorganization. He has also represented parties in securitization and CMBS transactions; and provided advice in connection with bankruptcy-remote structures and nonconsolidation issues.

Neil Robson is a senior associate in the London office of Schulte Roth & Zabel LLP. He has extensive experience providing regulatory advice to funds and managers regarding: FSA authorisation and compliance; cross-border issues in the financial services sector; market abuse; anti-money laundering and regulatory capital requirements; formations and buyouts of financial services groups and structuring and marketing of investment funds; agreements with customers; custodians and services providers; and, outsourcing arrangements.

[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.

©2011 The Hedge Fund Law Report. All rights reserved.

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

Schulte Roth&Zabel

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

[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

©2011 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
Schulte Roth&Zabel
www.hflawreport.com Volume 4, Number 38 October 27, 2011

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).

©2011 The Hedge Fund Law Report. All rights reserved.