



Distressed Debt & Claims Trading ADVISORY ■

APRIL 6, 2020

Secondary Loan Trading Considerations in Unsettling Times

By [*Ken Rothenberg*](#), [*David J. Hoyt*](#), [*Russell Chiappetta*](#), [*Mathew Gray*](#), and [*Jason Cygielman*](#)

The United States has experienced a bull market for nearly a decade. During this time, U.S. leveraged loan default rates have not gone much higher than 3% and, for the past few years, hovered between 1% – 2%. Bankruptcy cases and out-of-court restructurings were orderly with pre-packaged plans of reorganization, restructuring support agreements, and limited challenges, helping facilitate a relatively benign restructuring process. During this period, leveraged loans tended to trade on LSTA par/near par convention until either a payment default or a bankruptcy was filed.

We Are in Different Times Now

Due to the global pandemic of COVID-19, the leveraged loan market has quickly declined. Companies are being downgraded at a rapid rate, revolvers are being fully drawn, and loan spreads have ballooned, effectively closing the market for new leveraged loans. As a result, we can expect a severe funding crunch, higher default rates, and a significant increase in bankruptcy filings and restructurings. The last time we saw such a liquidity crisis was the great financial crisis of 2008–2009, when U.S. leveraged loan default rates ballooned to 10.5%.

As shown by the great financial crisis, during times of illiquidity in the loan markets, restructurings are less orderly, more challenges to senior secured lenders arise, and fraud is more likely to be exposed. Given the drastic change in the economy and the expected surge in bankruptcies, distressed borrowers will face more difficulties in garnering broad creditor support to facilitate pre-packaged and orderly bankruptcies.

In the current environment, we can expect an increased number of targeted actions against senior secured lenders, agents, sponsors, and other parties by debtors, creditors' committees, ad hoc groups, and equity committees, each trying to enhance their recovery relative to others in restructuring proceedings. In light of this, **market participants should consider the benefits to both buyers and sellers to trade stressed/distressed credits on LSTA distressed documentation (prior to a payment default or a bankruptcy filing before making such shift)**. Below is a high-level summary of some of the important reasons why market participants should consider utilizing distressed documentation and the risks of trading stressed/distressed loans on par/near par terms.

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

Enhanced Buyer Protections

When a buyer purchases a loan on par/near par terms, the buyer essentially receives a single representation from the seller that the loans being sold are free and clear of any adverse claim against title. However, when a buyer purchases loans on LSTA distressed documentation, the buyer receives robust protections through representations, covenants, indemnities, and other rights, including:

“No bad acts” representation

This is the most significant distressed representation and is intended to act as a catch-all where the seller will represent that it has not taken any actions (or failed to take an action) that will result in the buyer receiving less favorable treatment than any other similarly situated lender. **A bankruptcy court has the power to equitably subordinate or disallow a loan held by a buyer who purchased loans from a seller who committed a bad act or received a preference payment.** Even if the buyer is not aware of the bad act, most courts hold that the taint travels with the loan (and a seller cannot wash away its bad acts by selling its loans). **A buyer that purchases on LSTA distressed documents will have recourse against a seller that committed a bad act that results in the buyer’s loan being equitably subordinated or disallowed.** Notable bankruptcy cases where this issue has come up affecting secondary buyers of distressed debt include *Enron*, *KB Toys*, and *ASM Capital*.

“No bad acts” indemnity

The indemnification provision of the distressed documents includes a specific, enhanced no-bad-acts indemnity, which provides the buyer with recourse and indemnification rights against the seller to the extent the seller was either an “insider” or “affiliate” of the borrower/obligor or a party to an ad hoc group, creditors committee, or any other similar type of committee, which results, in either case, in the buyer being treated less favorably than other similarly situated creditors.

Additional key distressed buyer protections

Other important distressed buyer protections include:

- The seller has complied with credit documentation (e.g., not a defaulting lender).
- The seller is not a party to any document (other than credit documents and orders for which all lenders are subject) that could adversely affect the loans.
- The seller has not affected or received a setoff against the borrower.
- The seller has not received any written notice (other than those publicly available) that any payment or other transfer made to it may be void or voidable as a fraudulent transfer or as a preference.
- The buyer receives upstream chain of title and contractual rights against prior sellers that sold on distressed documents (able to track upstream payments).
- The buyer afforded indemnification rights (including recovery of legal expenses incurred) against the seller for damages resulting from (1) the seller’s breach of representations; or (2) a payment or setoff received by the seller that the seller did not return or disgorge when required to do so in connection with a restructuring or otherwise.

Buyer voting rights

In stressed/distressed situations, there is an increased likelihood that lenders will be asked to make more substantive, material decisions. It is therefore important for a buyer to have as much control over voting as possible. It is not uncommon in a stressed/distressed situation after parties close a trade that the seller remains entitled to make a decision on such loans (because a record date has been set before the closing). In these circumstances, **when parties close trades on distressed documentation, the seller will be contractually obligated to seek direction from its buyer before making a decision.** Conversely, **when trading par/near par loans, there are no express contractual obligations for a seller to follow the direction of its buyer.** Trading on par documents in a distressed environment may limit the buyer's rights to control key decisions.

Transferred Rights

In distressed situations, it is valuable for a buyer to acquire the right to all claims and causes of action that the seller may have against third parties, including claims against agents, representatives, contractors, attorneys, accountants, financial advisors, or any other entity relating to the credit being sold and assigned. These rights do not automatically transfer with the loan by law and must be acquired by contract. **LSTA distressed documentation always transfers rights to third-party claims in a broadly defined unambiguous manner,** while the form of assignment and acceptance used to transfer loans in par/near par trades can vary greatly. Some forms include these rights, others do not, and others contain ambiguous language that may require litigation to interpret.

Enhanced Seller Protections

Seller disgorgement protection

A distressed purchase and sale agreement also provides protections for a seller that are not afforded a seller when it sells on par/near par terms. Notably, **disgorgement protection does not exist for a seller when selling on LSTA par/near par documentation** when a bankruptcy court requires lenders to return or disgorge payments it receives for a loan that are later found to be a preference or a fraudulent transfer.

A situation could arise where, in between the trade date and settlement date of a loan trade, all the lenders receive non-ordinary-course payments from a distressed company that has not yet filed for bankruptcy. In such a scenario, on the settlement date of the trade, the buyer will receive a credit for its pro rata amount of such distribution from the seller. After the settlement date, a distressed borrower may file for bankruptcy, and the bankruptcy court may later determine that the credited payment was a preference or a fraudulent transfer and subject to disgorgement. The bankruptcy court would likely require the lenders that received the payment to return or disgorge such payment.

Using LSTA distressed trading documents would protect the seller by expressly obligating the buyer to promptly return any amount credited to the buyer that the seller is subsequently required to disgorge. Conversely, if the seller sold on LSTA par/near par terms, the seller will have no right to seek disgorgement for credited payment from its buyer. In the past, **the secondary loan trading market has seen the disgorgement issue be a painful reality for sellers that sold stressed/distressed loans on par/near par terms,** including in such credits as *General Motors*, *Tousa Inc.*, and *Ultra Petroleum*.

Eligible Assignee Representation

Another area where sellers receive enhanced protections on distressed documentation relates to transfer provisions. Credit agreements contain restrictions that limit how and to whom a loan may be sold. These transfer provisions have

become increasingly complex. Distressed documentation requires a buyer to provide a representation of its status under the credit agreement (whether it is a lender, an affiliate of a lender, a related fund, not a lender, etc.) so that a seller can determine how to properly structure the transaction and what consents and notices are required to comply with the credit agreement. If a buyer provides inaccurate information, a seller will have recourse and indemnification rights against the buyer for any losses or damages incurred. **Compliance with transfer provisions will be very important during economic distressed periods because there will be a heightened risk of challenges to noncompliant assignments, particularly to the extent a borrower/debtor, another lender, or other creditors may be able to receive a benefit from having such transfers declared void.** Recent examples of assignments that have been declared void for failure to comply with transfer provisions include both the Woodbridge and [Caesars](#) bankruptcy cases.

Resale Risk of Stressed/Distressed Loans Purchased on Par/Near Par

Shift date poll

Once the LSTA publishes a distressed shift date for a credit, typically the entire secondary loan trading market will begin trading such credit on distressed documentation. However, an important point for market participants to realize is that the **LSTA shift date does not determine whether a credit trades on par/near par terms or distressed terms. That determination is made by the parties when entering into a loan trade.**

It is critical to note that the **LSTA shift date operates retroactively.** In order for the LSTA to designate a shift date for a particular credit, a market participant must request that a shift date poll be initiated, which typically occurs *after* parties have agreed to use distressed documents for a trade. Once a poll has been initiated, the LSTA follows the LSTA [shift date rules](#) to determine whether a shift to distressed trading has occurred.

In making this determination, the LSTA first reviews trade data received from dealers to see if there is a consensus on whether market participants are trading a credit on par or distressed. If the trade data is inconclusive, the LSTA then reviews other public information relating to the applicable borrower, including the existence of any defaults, the industry in which the obligor does business, information published by rating agencies, and loan pricing. Due to the retroactive application of the shift date, there may often be a significant amount of distressed trading done in a credit well before a formal shift date has been published.

Step-up risk

If a buyer settles a loan trade on par/near par terms after a distressed shift date has occurred, then upon the buyer's resale of such loans, it will be required to make certain "step-up" representations, warranties, covenants, and indemnities on behalf of certain prior sellers, which the buyer would not have been required to make if it originally purchased the loans on distressed documents. Thus, **when a buyer purchases stressed/distressed loans on LSTA par/near par terms, the buyer runs the risk of being required to make representations, covenants, and indemnities not only on behalf of itself but also on behalf of other third parties for whom it will have no idea whether such statements are true or false.** Such step-ups include requiring a seller to make the "no bad acts" representation on behalf of prior holders of the loans. These step-ups increase a seller's potential liability in ways that dealers, hedge funds, CLOs, and other financial institutions typically do not contemplate at the time of trade. One way buyers can mitigate this step-up risk on resales is by purchasing stressed/distressed loans on LSTA distressed documentation before a shift date has been determined.

Conclusion

Given the risks of trading stressed/distressed credits on par/near par documentation, parties should strongly consider availing themselves of the protections afforded by trading leveraged loans on LSTA distressed documentation when credits become stressed, rather than waiting for a payment default or bankruptcy filing. There are many advantages afforded by trading stressed/distressed loans on distressed documentation for both buyers and sellers. As explained above, the determination of whether loans trade on par/near par terms or distressed terms is made by the parties at the time of trade (and not by whether the LSTA has published a shift date poll). The retroactive application of the LSTA shift date poll exposes parties that wait for a formal poll to be published before trading on distressed terms to added risks and liabilities, including the risk of being forced to “step up” for prior sellers on resale.

You can subscribe to future *Finance* advisories and other Alston & Bird publications by completing our [publications subscription form](#).

If you have any questions or would like additional information, please contact your Alston & Bird attorney or the following:



[Ken Rothenberg](#)
212.210.9594
ken.rothenberg@alston.com



[David J. Hoyt](#)
212.210.9490
david.hoyt@alston.com



[Russell Chiappetta](#)
212.210.9403
russell.chiappetta@alston.com



[Mathew Gray](#)
212.210.9410
mathew.gray@alston.com



[Jason Cygielman](#)
212.210.9511
jason.cygielman@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2020

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
 BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghai Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86.10.85927500
 BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
 CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
 DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
 LONDON: 5th Floor, Octagon Point, St. Paul's ■ 5 Cheapside ■ London, EC2V 6AA, UK ■ +44.0.20.3823.2225
 LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
 NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
 RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
 SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
 SILICON VALLEY: 950 Page Mill Road ■ Palo Alto, California, USA 94304-1012 ■ 650.838.2000 ■ Fax: 650.838.2001
 WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333