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LSTA Revises Secondary Trading Documents: Notable Changes to Disgorgement Rights, Tax Gross-Up Obligations, and Voting Rights

By Ken Rothenberg, David J. Hoyt, and Russell Chiappetta*

This article provides a summary of the changes the Loan Syndications and Trading Association made to their standard document in the wake of recent bankruptcies and circuit court decisions.

The Loan Syndications and Trading Association ("LSTA") published a revised suite of secondary par and distressed trading documentation that became effective for loan trades entered into on and after May 17, 2019. The most notable changes relate to disgorgement rights of sellers under the LSTA Chapter 11 Plan Proceeds Letter for Post-Effective Date Settlement of Distressed Trades (the "Proceeds Letter") and to tax gross-up obligations of sellers under substantially all of the LSTA's suite of secondary trading documentation, both for par and distressed.

DISGORGEMENT

When a borrower/debtor emerges from Chapter 11 bankruptcy proceedings and initial distributions have been made to its creditors, loan market participants settle open distressed trades pursuant to a Proceeds Letter. In certain cases, facts may arise whereby the bankruptcy court requires creditors that held claims as of the distribution record date to return proceeds previously distributed. Before the change made under the Proceeds Letter, a seller only had a clawback right from its buyer in the limited circumstances where a distribution was made to a seller by mistake. The disgorgement change in the Proceeds Letter now provides the seller with an unfettered right to claw back proceeds distributed by the seller to its buyer.

If a bankruptcy court requires a seller to return distributions to the bankruptcy estate, the seller will now generally have an unrestricted right to disgorge those distributions back from its buyer (to the extent the buyer

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previously had received the economic benefit of the distributions from its seller).

The prompt for this revision was the Chapter 11 bankruptcy case of Ultra Petroleum Corp. in the U.S. Bankruptcy Court for the Southern District of Texas. In that case, there was a dispute over whether pre-petition lenders and noteholders were entitled to a make-whole payment and post-petition interest. The dispute was not immaterial; it related to hundreds of millions of dollars.

Before the dispute was ultimately decided, the bankruptcy court confirmed Ultra's plan of reorganization, its plan became effective, and initial cash distributions were remitted to pre-petition lenders. The confirmed plan provided that, if the dispute was decided in favor of the pre-petition lenders, the pre-petition lenders would receive a subsequent distribution out of the bankruptcy estate relating to accrued but unpaid post-petition interest.

Once the prerequisites for use of a Proceeds Letter were realized in the Ultra bankruptcy case in April 2017 (i.e., plan confirmed, effective date occurred, and initial distributions made), loan market participants began settling open Ultra distressed trades under Proceeds Letters that generally included standard provisions that required the seller, following receipt of a subsequent distribution, to pass along the economic benefit of the distribution to its buyer.

On October 6, 2017, the Ultra bankruptcy court ruled for the pre-petition lenders in the dispute and ordered that approximately $400 million in reserves be released and distributed to pre-petition lenders and noteholders. However, the bankruptcy court acknowledged that its ruling could be appealed, and if the appeal were successful, the bankruptcy estate would be entitled to disgorge those funds previously distributed to the pre-petition lenders and noteholders.

This ruling put sellers that held Ultra loans as of the distribution record date and previously settled Ultra loan trades on a Proceeds Letter in an unenviable position. Once a record-date holder received its pro rata amount of the subsequent distribution related to the dispute, it would be obligated to pass along that amount to its buyer under the Proceeds Letter.

However, if an appeal were ultimately successful and the record-date holder was required to disgorge payments back to the bankruptcy estate, the seller/record-date holder would have no express right within the four corners of the Proceeds Letter to claw back the amount it had previously passed along to its buyer. This is because before the change made in the Proceeds Letter, the disgorgement right of a seller was limited to a mistake (e.g., a record-date holder received excess proceeds due to a calculation error).

The LSTA's modification to the Proceeds Letter will now protect sellers that are record-date holders (as well as downstream intermediate sellers in a chain of title) from this risk. From a fairness perspective, this change makes sense. If the seller is required to disgorge a distribution following a successful appeal, but the seller could not require return from its buyer (who received the economic benefit of the subsequent distribution), the buyer would receive an economic windfall (i.e., receive the economic benefit of the initial decision made in the dispute without the related risk that it ultimately may be overturned on appeal).

A court of law arguably might find that, notwithstanding the absence of the express disgorgement right of the seller under that scenario, a seller would have clawback rights on principles of equity and fairness. Regardless, the four corners of the Proceeds Letter now provides sellers with express contractual disgorgement protection beyond mistakes.

SELLER TAX GROSS-UP OBLIGATIONS

Perhaps the most impactful economic change affecting market participants relates to expanded tax gross-up obligations placed on sellers. This change impacts substantially all the LSTA secondary trading documentation (par confirm, distressed confirm, distressed purchase and sale agreement, par participation agreement, distressed participation agreement, and Proceeds Letter).

Before this revision, a seller only had tax gross-up obligations to its buyer if a Foreign Account Tax Compliance Act ("FATCA") withholding occurred on payments made to a seller from the borrower. Under those circumstances, if the buyer's distribution would not have been withheld under FATCA had the distribution been made directly to the buyer from the borrower, then the seller was obligated to remit a grossed up amount to its buyer so that the buyer would receive the full distribution (without any FATCA withholding deducted).

Under the revised LSTA suite of documents for both par and distressed trades, if the buyer's distribution would not have been subject to a withholding if the buyer had received the payment or distribution directly from the borrower/debtor (i.e., the buyer had been the direct "lender"), and if a seller's distribution is withheld upon for any reason (including FATCA) for an amount it is obligated to pass along to its buyer under the governing LSTA documents, the selling party is now required to gross up the distribution to the extent of the withholding.

Common scenarios where this could occur include when a seller is obligated to pass along any distribution it received to its buyer under the revised LSTA form participation agreements or revised Proceeds Letter.

For example, if tax withholding applies to a seller's interest payment because the seller is organized in a country where the borrower is required to withhold, but the same payment if made directly by the borrower to the participant would not have required any withholding, then the seller/grantor of the participation will be required to gross up the distribution so the participant receives the full distribution free of any withholding.

The situation could also affect a seller under a closed trade where a record date for distributions had been established and the seller receives a subsequent distribution that it is required to pass along to its buyer. Again, under that scenario, if the buyer's distribution would not have been withheld upon if the buyer had been the lender of record and received the payment directly, then the seller must gross up the distribution remitted to its buyer.

VOTING

Another notable change to the LSTA suite of secondary trading documentation relates to voting rights. These changes impact the par/near par participation agreement, the distressed participation agreement, the standard terms of the distressed purchase and sale agreement, and the Proceeds Letter.

The most prevalent situation where a buyer will have voting rights will be under an LSTA participation agreement, both for par and distressed. Under the LSTA form of participation agreement, voting rights are not automatically granted. The parties must agree whether voting rights will be granted to the buyer. If the parties agree that voting rights are granted, generally a seller will have to follow its participant's direction to the extent such vote is divisible. If the vote is not divisible, then a seller only needs to follow the buyer's direction if the buyer's participation interest controls the majority of the vote.

For example, if a seller has participated $10 million of loans to a participant and the seller likewise holds $5 million of loans for its own account and a vote on the loans is required, the buyer would generally control the vote if majority voting rights were granted (since the buyer would hold a majority interest of $10 million of the seller's $15 million loan holdings).

The modification to the voting section of the participation agreements, for both par and distressed (as well as the distressed purchase and sale agreement), now makes clear that under certain circumstances, a seller does not need to follow its buyer's/participant's direction even when the buyer/participant controls a majority.

For example, if the seller reasonably determines that following (1) the buyer's direction could result in a liability to the seller and the seller has not been provided adequate indemnity; or (2) such instructions could violate applicable law, rule, or order or the underlying credit documents, then the seller does not need to follow its buyer's direction. Before this modification, these exceptions were only expressly provided for within the four corners of the applicable LSTA agreements in situations where the vote was divisible.

These modifications to voting rights were not made to the terms and conditions of trade confirmations for either par or distressed because the standard terms and conditions for par/near par trade confirmations and distressed trade confirmations do not provide a buyer with any express contractual voting rights within the four corners of those agreements. There was no modification to be addressed.

The only express contractual rights provided to a buyer for open and unsettled trades under the terms of LSTA par and distressed confirmations are set forth in the standard terms and conditions section related to "syndicate information." That section provides that if a buyer had requested syndicate information and the buyer was not a lender of record on the trade date, the seller shall use commercially reasonable efforts to provide the buyer with notice of "all amendments and waivers of the Credit Documents arising between the Trade Date and the Settlement Date (but Seller need not solicit a vote from Buyer with respect to any such amendment or waiver)."

Market practice customarily provides that, to the extent practicable, sellers will contact their buyers on unsettled trades and ask the buyers for direction with a qualification that the seller cannot guarantee that it will be able to follow that direction and that the seller shall have no liability for its failure to follow such direction.

NO BAD ACTS COVENANT

A fundamental representation and warranty under distressed LSTA trading documentation provides that a seller has not taken an action (or failed to take an action) that will result in its buyer receiving less distributions or less favorable treatment than received by other similarly situated creditors (commonly referred to as the "no bad acts rep"). The Proceeds Letter was revised to add a no bad acts "covenant" for subsequent distributions. This modification addresses that the no bad acts rep applies solely to actions taken (or not taken) up to the settlement date and does not apply to future actions.

Since under a Proceeds Letter all distributions will be made by the bankruptcy estate to the distribution record-date holder of the loans (and not by the estate to any subsequent downstream buyer), the concept addresses the fact that after parties close a Proceeds Letter, a record-date holder may receive subsequent distributions that it will be required to pass along to its buyer.

In effect, the Proceeds Letter acts as a quasi-participation interest. With the addition of a no bad acts covenant, a downstream buyer will now have recourse up the chain to its record-date seller if the record-date seller is treated worse than other similarly situated creditors in the remittance of any subsequent distributions as a result of an action (or inaction) specific to the seller.

ERISA

The LSTA trading documents were also modified to reflect the removal of the Department of Labor's fiduciary rule that expanded circumstances under which a person would be considered a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA") or Internal Revenue Code. The fiduciary rule generally became applicable on June 9, 2017; however, the Department of Labor postponed the application of certain portions of the rule to reexamine the rule and certain exemptions.

After numerous court challenges, on June 21, 2018, the U.S. Court of Appeals for the Fifth Circuit issued a mandate vacating the fiduciary rule. After the ruling, the ERISA provisions in the LSTA trading documents were modified, reverting to the provisions in effect before the LSTA's publication of updated documents on June 9, 2017.

The changes the LSTA had incorporated relating to the fiduciary rule, including any investment advice that may accompany purchases and sales of loans, have now been eliminated.