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WHEN SHOULD A LOAN TRADE AS 'DISTRESSED?'

Guest Analysis

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As bank loan prices decline to unprecedented levels in the wake of the sub-prime meltdown, it has become increasingly unclear when a bank loan should be traded as "par/near par" or "distressed." The implications of such categorizations are very significant.

Prior to the current liquidity and credit crises, the market value of bank loans was viewed to directly reflect the credit quality of the asset, with bank loans trading below 90 cents on the dollar generally being considered "distressed." However, the recent unprecedented market price declines of many bank loans have been attributable to many factors not directly related to the credit quality of the borrower, including a large supply and demand imbalance and concerns relating to the potential recession.

These sharp declines in prices have caused the debt of borrowers with strong credit quality characteristics to trade at price levels that have typically been associated with "distressed" credits.

Price is No Longer the Primary Indicator

Recently, the Loan Market Trading Association ("LSTA") issued a Loan Market Advisory urging buyers and sellers of bank loans to look beyond price as the dispositive factor in determining whether a trade should be confirmed and settled on distressed or par/near par documentation. In the current market, this uncertainty has led to numerous situations where a bank loan relating to a borrower under a single set of loan documents is simultaneously traded as distressed and par/near par depending upon the varying views of the parties trading the debt. This type of "mixed market" trading has recently caused a fair amount of controversy and confusion, as the implications of a bank loan trading as par/near par or distressed can be very significant to the relevant parties. If a bank loan is trading as "distressed," a standardized purchase and sale agreement (the "Distressed Documents") published by the LSTA would be utilized containing significant representations, warranties, covenants and indemnities from the seller for the benefit of the buyer. If the bank loan is trading as "par/near par," only an assignment (the "Par Documents"), typically appearing as an exhibit to the related loan agreement, would be utilized. Par Documents contain very few of the documentary protections set forth in the Distressed Documents.

The risks confronting participants in a mixed market can therefore be considerable.

These risks arise when a buyer confirms and settles a trade for a bank loan on Par Documents after the date for which there is general consensus in the market that such bank loans should be trading on Distressed Documents (the date of such transition is the "shift date"). In order for an original buyer to sell loans to a prospective assignee, such buyer may be required to provide such assignee with additional representations, commonly referred to as "step-up representations." The step-up representations force a seller to make certain representations to the buyer not only on its own behalf, but also on behalf of each prior seller who traded the bank loan on a par basis after the shift date.

When Is a Bank Loan Distressed?

Unfortunately, there is no market-standard definition of a "distressed" bank loan. Whether a bank loan is trading as par/near par or distressed is a decision for the parties to agree upon at the time of trade. The "User's Guide For LSTA Distressed Trading Documentation," published by the LSTA, refers to debt that is to be considered "distressed" as "debt that is said to be in some degree of financial distress that impairs the prospects of full and timely payment." Several factors are relevant in determining whether a bank loan is distressed, including (i) price, (ii) whether the party which is primarily obligated to repay the loan is in bankruptcy or reorganization, has experienced a credit-rating downgrade or faces any credit-specific credit issues (i.e., litigation liability issues, public relations concerns), and (iii) industry-wide issues (i.e., legislation adversely affecting a particular sector).

How Can Risks in a Mixed Market Be Minimized?

Under mixed market conditions when the parties are uncertain about the trading status of a bank loan, market participants can take the steps outlined below to minimize their risks.

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Discuss Documentation at the Time of Trade

A bank loan trade typically begins with an oral agreement which is later evidenced by a written trade confirmation. The form of the trade confirmation for distressed bank loans will differ from the trade confirms used for par/near par trades.

In addition to the critical issues of price, quantity and interest treatment, the parties should expressly agree upon whether the bank loan will be traded on Par Documents or Distressed Documents.

This is especially important for purchasers that cannot acquire distressed debt.

In addition, parties should note that under New York law, oral agreements relating to trades are likely to be legally binding, provided the material trade terms have been established.

It is essential that the parties have a clear understanding as to whether the bank loan is being traded as distressed before an oral agreement is reached.

Research Market Practice Regarding Documentation

To the extent possible, counterparties to a bank loan trade should canvass the market for information on how the credit in question is being traded before agreeing to a trade. In mixed market conditions where a credit is selling on both Distressed Documents and Par Documents, sellers will be motivated to sell on Par Documents to avoid making representations and thus assume potential liability, while conversely buyers will be motivated to buy on Distressed Documents in order to obtain the full protections of the seller's representations and warranties and thereby avoid risks that they may be required to provide step-up representations upon any future assignment of such credit.

It is important to have the best information available about the credit, including knowledge of the market practices regarding related documentation, before completing a trade.

If a credit is trading both as par and distressed, buyers of such credit should insist on confirmation and settlement on Distressed Documents. By employing this strategy, a buyer eliminates the potential risk of having to provide step-up representations upon subsequent sales. A buyer also avoids the potential liability that arises when a credit purchased on Par Documents, which contain very limited representations and warranties, is subsequently sold on Distressed Documents, which contain more stringent representations and warranties. In such a case, the buyer would be exposed to potential claims from the subsequent buyer without the same level of recourse to the prior seller.

Match Trading Inventory

If a counterparty has significant buying and selling volume in a credit and finds that the credit is trading on both Distressed Documents and Par Documents, it is wise to try to match the inventory of purchases and sales. Par/near par purchases of the debt should be paired with par/near par sales, while distressed buys should be matched with subsequent distressed sales. This practice will help minimize the risk of having to make step-up representations and the risk of exposure that occurs when buying on Par Documents, and thereafter selling on Distressed Documents.

Conclusion

There are a number of challenges and risks confronting market participants in a mixed market where a bank loan arising under a single loan agreement may be trading simultaneously as par/near par or distressed. Market participants can, however, adopt a number of practices and procedures to mitigate such risks.

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