SEWARD & KISSEL LLP

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Shift Date Controversy

On January 12, 2010, the LSTA released shift date guidelines whereby purchasers and sellers of a particular credit are advised to accept as binding the shift date for such credit published by the LSTA. In the absence of a published shift date, purchasers and sellers are advised to request that the LSTA poll the market to establish a consensus determination. Although these guidelines have largely succeeded in managing shift date expectations among market participants, they are not a one-size-fits-all solution. In particular, it is not clear if the guidelines provide a methodology for determining the shift date to be used for step-up purposes when a credit shifts multiple times between par and distressed documentation during a relatively brief period of time, a situation that has been arising with increasing frequency.

In recent months, considerable discord has arisen among distressed debt trading participants regarding the market convention for transferring a credit that has multiple distressed and par shift dates all within a relatively short time frame. The shift date has significant implications for purchasers and sellers under these circumstances, most notably when a purchaser confirms a trade on par documents, and one or more intervening shift dates occur before the date of settlement. While the LSTA touched upon this scenario in its February 2, 2011 advisory entitled "Distressed Shift Dates" (the "Advisory"), it is not clear whether the Advisory's conclusions can be extended beyond its narrow fact pattern. The Advisory by the LSTA has done a great deal to minimize these potential shift date disputes, but a host of questions remain regarding the practical application of such measures in today's volatile trading environment.

The Advisory uses the following theoretical example:

- 2009 – Market trades a particular credit on par documents.
- January 1, 2010 – (the "First Distressed Shift Date"). The market shifts to trading credit on distressed documents.
- April 1, 2010 – (the "Par Shift Date"). The market shifts back to trading credit on par documents.

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The War Over Credit Bidding In Chapter 11 Continues...

On October 5, 2010, Judge Bruce W. Black, Bankruptcy Judge for the Bankruptcy Court for the Northern District of Illinois issued orders in the chapter 11 case of *River Road Hotel Partners, LLC*, that not only upheld the right of secured creditors under the Bankruptcy Code to credit bid in any sale involving the secured creditors' collateral, but explicitly rejected the holding of the Third Circuit in *In Re Philadelphia Newspapers, LLC*[1] that denied secured creditors an inherent right to credit bid under the Bankruptcy Code. Judge Black relied on the dissent in *Philadelphia Newspapers* to hold that debtors may not use section 1129(b)(2)(A)(iii) of the Bankruptcy Code to circumvent a secured lender's right to credit bid and must instead comply with Bankruptcy Code section 1129(b)(2)(A)(ii), which makes any asset sale subject to a secured lender's right to credit bid.

Credit bidding allows a senior secured lender to make a bid to purchase the debtor's assets in a bankruptcy sale by bidding part or all of its claim against the bankrupt debtor as currency for the assets of the debtor that comprise the secured lender's collateral without having to expend additional capital. Allowing a secured lender to credit bid is generally viewed as a way to ensure a proper valuation of its collateral, regardless of whether or not such a secured lender's credit bid is ultimately accepted as the highest and best bid. Until recently, allowing a secured lender to credit bid was not a controversial practice. However, the majority in *Philadelphia Newspapers*, basing their decision on the Fifth Circuit decision in *In re Pacific Lumber Co.*, turned credit bidding analysis on its head, finding that section 1129(b)(2)(A) does not afford secured lenders an inviolable right to credit bid. Instead, the Third Circuit found that

[1]We reported on the *Philadelphia Newspapers* decision in the October 2010 *Distressed Debt Report*.

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• December 1, 2010 – (the "Second Distressed Shift Date"). The market shifts to trading credit on distressed documents for the second time.

In the Advisory, the LSTA recommends that where there are multiple published distressed shift dates, the parties should adopt the latest shift date in time for trades entered into on or after the most recent published shift date. In this example, a party trading on par documents during a par trading period who does not settle the transaction until after the Second Distressed Shift Date would be required to step-up to the Second Distressed Shift Date (December 1, 2010) in its subsequent sale provided that the trade confirmation for the subsequent sale was entered into on or after the Second Distressed Shift Date. In this case, the seller in the subsequent trade would need to provide its buyer with enhanced representations and indemnities that it did not itself receive.

While the LSTA's example provides a consensus with respect to its specific fact pattern, it is unclear whether it is uniformly applicable to all credits that trade with multiple shift dates during a relatively short period of time. Consider the following scenario:

• 2009 – Market trades a particular credit on par documents.

• January 1, 2010 – (the "First Distressed Shift Date"). The market shifts to trading credit on distressed documents.

• May 1, 2010 – (the "Par Shift Date"). The market shifts back to trading credit on par documents.

• June 1, 2010 – (the "Second Distressed Shift Date"). The market shifts to trading credit on distressed documents for the second time.

In this fact pattern, the length of time between shift date changes is significantly shorter than in the LSTA's example. Here, the time between the First Distressed Shift Date and the Second Distressed Shift Date is four months, while in the LSTA's example it is one year. Moreover, in the present example, the intervening par trading period spans a month. In contrast, in the LSTA's example, the credit continues trading par for eight months.

The multiple shift dates relating to the Graceway Pharamaceuticals First Lien Credit Agreement dated May 3, 2007 provide a recent example of a similar fact pattern. The LSTA first issued a shift date poll for Graceway in March, 2010, indicating that Graceway began trading on distressed documents on March 15, 2010. A subsequent poll showed the market shifted back to par trading on August 11, 2010. Finally, the debt resumed trading on distressed documents (the second distressed shift date) less than a month later, on September 9, 2010.

As a result of the relatively brief periods of time between shifts in distressed and par trading in Graceway, many market players had both par and distressed paper trading simultaneously. Moreover, some parties did not recognize the August shift to par, and traded on distressed documents throughout; while others adhered to the LSTA shift date polls and traded accordingly. This created a market where sellers who settled their prior Graceway trades on par documents after the distressed shift date were compelled to provide their buyers with step-up representations.

Rapidly changing shift dates can lead to market uncertainty as to what the appropriate trading designation should be at the time of trade. As a result, some parties may trade on par documents while others trade on distressed documents, not certain what the appropriate trading designation should be at the time of trade. Consequently, some parties will give distressed representations when unnecessary, and others will insist on trading on distressed documents when the LSTA information would dictate otherwise. This uncertainty could lead to a number of consequences, including delays in trade generation, protracted settlement dates and debt-specific liquidity problems, as parties haggle over documentation designations and step-up requirements.

Whether the brevity of the multiple shift date periods would impact the LSTA's analysis is not addressed in its Advisory. Unfortunately, while the market remains volatile, multiple distressed shift dates may become more common, bringing with them a number of issues that could delay settlement and hamper debt trading. While the LSTA's recent measures represent a great stride in furtherance of market consistency regarding the appropriate interpretation of shift dates, it is likely that further guidance in this area will be necessary.

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subsections 1129(b)(2)(A)(i), (ii) and (iii) contain three separate means by which a secured creditor's claim may be satisfied. The Third Circuit noted that although subsection (ii) provides that, subject to a secured party's right to credit bid as set forth in section 363(k) of the Bankruptcy Code, the property may be sold, free and clear of the secured party's liens with the liens to attach to the proceeds of the sale, subsection (iii) provides for the secured creditors to receive the indubitable equivalent of their secured claims. The Third Circuit found that "indubitable equivalent" encompasses sales without credit bidding, so long as the sale yields the secured creditor the value of its secured claim.

The dissent in *Philadelphia Newspapers*, upon which Judge Black relied, argued that section 1129(b)(2)(A)(ii) set forth the only way that property could be sold, and that subsection (iii) was meant simply to cover any type of recovery that did not involve the methods set forth in subsections (i) and (ii). Having held that secured creditors have an undeniable right under section 1129(b)(2)(A) to credit bid as set forth in section 363(k), Judge Black went on to analyze whether cause existed under section 363(k) to deny the secured lenders the right to credit bid. Finding that such cause did not exist, Judge Black upheld the secured lenders' right to credit bid.

River Road has appealed Judge Black's order directly to the Seventh Circuit Court of Appeals. Oral argument in the appeal is currently scheduled for April 7, 2011. Should the Seventh Circuit affirm the bankruptcy court's order and sustain secured lenders' rights to credit bid, its decision would be at odds with the Third Circuit's decision in *Philadelphia Newspapers*. Such a split in the Circuit Courts could make the issue ripe for review by the United States Supreme Court.

Because there is still uncertainty as to whether the Bankruptcy Code preserves a secured creditor's right to credit bid, secured lenders should insist that the terms of any financing agreement and any financing order in a chapter 11 case that affects their collateral protect and secure their right to credit bid.

LSTA Weighs In On The Future Of Loan Participations Under Dodd-Frank

The syndicated loan market has long relied on the "loan participation" as an efficient alternative transfer structure to settling via assignment. Credit agreements almost universally contain provisions allowing lenders to sell assignments and participations. However, there is concern in the syndicated loan market that the Dodd-Frank Act's comprehensive scheme for regulating swaps, which would impose costly and burdensome registration and reporting requirements on swap participants, may also encompass loan participations.

A participation grants the buyer a beneficial economic interest in the payments the borrower owes to a lender under the terms of the credit agreement. However, unlike under an assignment, the buyer of a participation does not become a lender under the credit agreement or hold legal title to the debt. Instead, the buyer "participates" in the credit through a current lender. There are typically few rights granted to the participant under the credit agreement, and there is no direct relationship between the borrower and the participant. Depending on the terms of the participation agreement, voting rights may or may not be transferred to the participant.

In relevant part, the new definition of "swap" includes:

> "any agreement, contract, or transaction… that provides… for the exchange… of 1 or more payments based on the value… of 1 or more interest of other rates, … instruments of indebtedness, … or other financial or economic interests or property of any kind, … and that transfers… in whole or in part, the financial risk associated with a future change in any such value… without also conveying a current or future or indirect ownership interest in an asset… or liability that incorporates the risk so transferred…"

There is uncertainty in the marketplace as to whether this definition, which focuses on the transfer of the financial risk without a transfer of ownership in the instrument, could be interpreted to encompass loan participations.

It is the prevailing view among commentators that U.S. participations will most likely be safe from being wrapped up into the Dodd-Frank definition of "swap" and the bulk of the concern has been reserved for participations in European and Asian loans. Participations in U.S. loans are typically drafted using the standard documentation published by the Loan Syndications and Trading Association (the "LSTA"). The LSTA model of loan participation specifically provides that the participation is intended by the parties to be treated as a sale by the grantor and a purchase by the participant. In Europe and Asia most participations are drafted using the standard documentation published by the Loan Market Association (the "LMA"). This model of participation does

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not transfer an interest in the underlying debt but rather creates a current debtor-creditor relationship between the parties.

As mentioned previously, even in a LSTA style participation, voting rights are not necessarily transferred from the grantor to the participant, and no direct relationship is created between participant and the borrower, leaving room for doubt that can only be eradicated by the regulators. The LSTA submitted a comment letter on January 25, 2011 to the Commodity Futures Trading Commission and the Securities and Exchange Commission, who will be responsible for rulemaking in these areas, urging them to specifically carve out both LMA and LSTA style loan participations from the definition of "swap." In their letter the LSTA emphasizes that LSTA and LMA style participations each have the practical effect of transferring both a current and future beneficial ownership in a loan, the current transfer being evidenced by the participant's ability to determine the actions taken by the grantor as a lender under the credit agreement (i.e. to direct their vote), and the future transfer by the parties agreement to make commercially reasonable efforts to elevate the participation to an assignment at a later date.

In their comment letter, the LSTA urges the regulators to recognize that regulating loan participations as swaps would be detrimental to the syndicated loan market. Dodd-Frank's comprehensive scheme for regulating swaps, which would include registration requirements, capital and conduct requirements on entities required to register, central clearing and margin requirements, reporting obligations, and position limits, would be impractical and cost-prohibitive if applied to loan transactions. The burden of this regulatory scheme would effectively prohibit the use of the loan participation as an alternative transfer structure, and the syndicated loan market would need to move towards settlement by assignment only. This would remove flexibility in trade settlement, lead to protracted settlement times, and potentially freeze participants out of the market. The full text of the LSTA's comment letter and the related press release can be found on their website: www.lsta.org.

Lender Appeals Predatory Lending Decision In Yellowstone Mountain Club Proceeding

In *In re Yellowstone Mountain Club* the Bankruptcy Court for the District of Montana found that Credit Suisse engaged in predatory lending by entering into a $375 million dollar credit agreement with Yellowstone Mountain Club, a developing ski and golf community and the debtor in the bankruptcy proceeding. The court found that the actions of Credit Suisse met the "gross and egregious conduct" standard required for equitable subordination involving a non-insider non-fiduciary. As a result, the court equitably subordinated Credit Suisse's secured first lien loan to the claims of unsecured creditors.

A number of factors influenced the court's decision. While Credit Suisse engaged both a law firm to conduct legal due diligence and an appraisal firm to provide an independent assessment of Yellowstone's cash flows, it relied "exclusively on the historical and future projections" provided by Yellowstone and its controlling shareholder, and never requested audited financial statements from Yellowstone. The court noted that the projections upon which Credit Suisse relied almost exclusively "bore no relation to [Yellowstone's] historical or present reality." The court found that the loan product offered by Credit Suisse accrued to the sole benefit of Credit Suisse and Yellowstone's controlling shareholders, while the creditors of the community "bore all the risk of loss," as the community was left "too thinly capitalized to survive." According to the court, the "most shocking aspect" of the loan product was that it allowed the controlling shareholder to take out "a substantial portion" of the loan proceeds as a distribution. The court stated that "a sophisticated lender such as Credit Suisse had to have known what a distribution would do to Yellowstone's financial statements, and in particular, their balance sheets, yet Credit Suisse proceeded with the loan" in order to earn its large fee.

The *Yellowstone* decision, which is currently being appealed to the District Court of Montana, could have major ramifications on the secondary loan trading market. Similar accusations of predatory lending made in the future could significantly harm a credit's liquidity by creating fear in market participants that their claims could be subject to equitable subordination if the borrower files for bankruptcy. This added layer of uncertainty could ultimately result in downward pressure on trade prices.

In a related case, a class action lawsuit was filed in the District Court of Idaho in January of 2010 alleging that Credit Suisse (among others) targeted resort developers and engaged in predatory lending practices similar in nature to those alleged in *Yellowstone*. That litigation is ongoing.

Heads up:

- **LSTA Publishes New Model Credit Agreement Provisions.**
  On March 25, 2011, the LSTA published new Model Credit Agreement Provisions (MCAPs). The MCAPs include the boilerplate provisions typically found in any credit agreement and have been widely adopted by the syndicated loan market since they were first released in 2005. The new MCAPs now include model defaulting lender language. This language provides that a lender is a defaulting lender if it, or its parent company, has become the subject of a bankruptcy proceeding, or if it has failed to fund a portion of its loans within two days of being required to fund, has notified the agent that it does not intend to comply with its funding obligations (or failed to confirm that it will comply) or made a public statement to that effect. The MCAPs are scheduled to be recirculated with revised tax language in the second quarter of 2011.

- **Tribune Bankruptcy Deadlock**.
  Tribune Co. bondholders filed a revised bankruptcy reorganization plan for the media company on March 28, hoping to overcome objections by senior creditors. On March 18, after two weeks of testimony regarding two competing restructuring plans, U.S. Bankruptcy Judge Kevin Carey described the case as "deadlocked," noting he saw strengths and weaknesses in both plans and warning he may confirm neither. Judge Carey encouraged the conflicting parties to reach a settlement. If they cannot and the Judge does not select one plan over the other, he may appoint a Chapter 11 trustee to decide the case. This could result in months of delay in order to bring the trustee up to speed.

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If you have any questions or comments about this Newsletter, please feel free to contact any of the attorneys in our Distressed Debt Group via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name followed by **@sewkis.com**.

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