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News for People Tracking Distressed Businesses

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Distressed or Not?

Market Environment Complicates Debt Evaluations

by Julie Schaeffer

As bank loan prices have declined to unprecedented levels in the wake of the subprime meltdown, it has become increasingly unclear when a bank loan should be traded as distressed, and that's creating risks for counterparties to a trade. However, Greg B. Cioffi and Kalyan Das, partners in Seward & Kissel's distressed debt group, and Renee Eubanks, a senior associate in the same group, have some tips for making the determination.

There is no standard definition of a "distressed" bank loan. The Loan Syndications and Trading Association's (LSTA's) user's guide for distressed trading documentation simply states that distressed debt is "debt that is said to be in some degree of financial distress that impairs the prospects of full and timely payment."

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As a result, the counterparties to a bank loan trade typically agree whether the loan is distressed or par/near par at the time of trade. Factors they might consider include price; whether the party that is obligated to repay the loan is in bankruptcy or reorganization, has experienced a credit rating downgrade, or faces any credit-specific credit issues; and industry-wide issues, such as legislation adversely affecting a particular sector.

In the past, price may have been the major factor, as bank loans trading below 90 cents on the dollar were generally considered distressed, says Cioffi.

In the wake of the subprime crisis, however, bank loan prices have declined substantially. The average price of a leveraged loan fell from par to a record low of 86.28 cents on the dollar in April, according to Standard & Poor's data. Prices have since climbed to 87.32.

Not all of this decline is attributable to the credit quality of the borrower, however. Other factors include a large supply and demand imbalance and economic worries, says Cioffi.

As a result, bank loans to borrowers with strong credit characteristics are often trading at prices that have typically been associated with distressed loans, so the market value of the bank loan does not directly reflect the credit quality of the asset.

In response, the LSTA recently issued an advisory urging buyers and sellers of bank loans to look beyond price as the deciding factor in determining whether a trade should be considered distressed or par/near par. "The LSTA believes that, while a price may be an important indicator of the likelihood of default, a price can be indicative of many other factors and therefore should not, in itself, be determinative of whether distressed or par/near par documentation is appropriate," the advisory stated. "Accordingly, while the parties to a loan trade transaction are, of course, free to agree to any settlement terms they wish, the LSTA believes that the decision... should take into account the full range of factors and considerations about the borrower and the loan, including, but not limited, to its market price."

This uncertainty, says Cioffi, has led to "numerous situations where a bank loan... is simultaneously traded as distressed and par/near par depending upon the varying

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views of the parties trading the debt."

The problem with that is that a bank loan's trading status of par/near par or distressed can have significant implications for the parties involved.

For example, if a bank loan is trading as distressed, a standardized purchase and sale agreement published by the LSTA - a "distressed document" - is typically used to make explicit "significant representations, warranties, covenants, and indemnities from the seller for the benefit of the buyer," says Eubanks.

On the other hand, if a bank loan is trading as par/near par loan documents, a purchase and sale agreement called a

"par document," which contains very few of these protections, is used.

According to Das, "under mixed-market conditions when the parties are uncertain about the trading status of a bank loan," counterparties to a bank loan trade can take a number of steps to minimize any resulting risks.

The first is discussing documentation at the time of the trade. "A bank loan trade typically begins with an oral agreement (which, under New York law, is likely to be legally binding provided the material trade terms have been established). It is later evidenced by a written trade confirmation," explains Das. "In addition

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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."

The second is researching market practices regarding documentation. "In mixed market-conditions, sellers will want to sell on par documents to avoid making representations and thus assume potential liability; conversely, buyers will want to buy on distressed documents in order to obtain the full protections of the seller's representations and warranties," Cioffi notes. As a result, he suggests counterparties canvass the market for information about how the bank loan in question is being traded, and if it is trading both as par and distressed, buyers should insist on confirmation and settlement on distressed documents. "By employing this strategy, the buyer 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."

Finally, counterparties that have significant buying and selling volume in a credit who find that the credit is trading on both distressed and par documents should 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," says Eubanks. "This practice will help minimize the risk that occurs when buying on par documents, and thereafter selling on distressed documents." □