

CLIENT ALERT

How to Buy a Distressed Loan

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The secondary loan market uses a variety of transfer structures and settlement conventions to move the risk of owning a commercial loan from a seller to a purchaser. The widely-used distressed purchase and sale agreement (currently published in the U.S. by The Loan Syndications and Trading Association, Inc.) is derived from asset sale and assignment templates used by private law firms in the 1990's. This article briefly describes the purpose and function of a purchase and sale agreement (a "PSA") tailored for distressed loans.

A distressed PSA is a purchaser-friendly document designed to transfer economic ownership of the loan from seller to purchaser and re-allocate between the parties certain "distressed-asset risks," leaving those behind with seller and providing purchaser with corresponding recourse in the event such risks surface in the future.

Modern credit agreements contemplate that lenders may at some point sell their loan positions, and to facilitate such potential sales, a simple assignment agreement (an "A&A") is generally attached as an exhibit. The par or near-par market considers an A&A to be adequate documentation for the settlement of a par loan trade. Distressed PSA's build upon the straightforward documentation used in the par or near-par loan market.

Under an A&A:

- Seller sells the loans and makes to purchaser a "good title" and other basic representations.
- On the effective date, the administrative agent records the transfer of the debt on the official books and records of the lending syndicate, the new owner becomes the "lender of record" and principal and interest payments on the loans begin to flow to purchaser.
- The A&A may also provide for the transfer of seller's claims, suits and other legal causes of action that arise under the credit agreement. These claims do not transfer automatically by law; therefore, such contractual transfer provisions afford purchaser with an important ancillary right of recovery, and thus are incorporated as well into a distressed PSA.
- The A&A does not, and is not intended to, protect purchaser from any future impairment of the loans.

An A&A, while slender, is good enough for the par market because of an underlying commercial assumption: if a loan is trading at par, then the probability of repayment is high. A par purchaser believes it will recover 100% when the borrower repays the loan in full at maturity, or when purchaser resells the loan in the secondary market.

However, when a borrower is stressed or distressed, repayment of the loan at maturity is unlikely and the optimistic assumptions underlying par trading evaporate. Distressed purchasers acquire stressed and distressed loans at a discount and generally focus on three legal risks:

- Equitable subordination/Recharacterization—the risk of the loans being subordinated or recharacterized as equity (resulting in repayment after senior debt or less than other lenders, or on a *pari passu* basis with equity) because of

seller's close relationship with the borrower (e.g., being an insider or an affiliate), or seller's historical bad conduct (e.g., controlling a borrower's operations for an ulterior motive causing losses to be incurred by other creditors).

- Impairment—the risk that the loans are subject to any claim, defense, setoff, litigation or other defect that could reduce the value of the loan.
- Disgorgement—the risk of repaying the borrower, administrative agent or any other third party for payments or other distributions received by seller (or any prior owner) in respect of the loans.

The distressed PSA functions as a “wrap-around agreement” between the seller of the loans and the purchaser; it supplements the A&A and integrates all terms of trade into one comprehensive document. The distressed PSA (i) provides purchaser with extensive rights under the credit agreement and all related documents, including the right to receive any and all distributions made on the loans after the settlement date (whether under the credit documents or pursuant to a restructuring or reorganization of the debt), (ii) gives purchaser a broad range of ancillary claims against seller, any prior holder of the loans and certain third parties, (iii) ensures a diligent purchaser's assumptions about the loans are true and correct, and (iv) gives comfort to purchaser that seller's status and its prior acts and conduct will not diminish the value of the loans, as compared to any other lender's loans.

Under a distressed PSA:

- In addition to the loans, seller explicitly transfers to purchaser an extensive set of ancillary rights, including (i) amounts owed to seller (or any prior owner of the loans) under the credit documents, (ii) any proof of claim filed in respect of the loans, (iii) predecessor transfer agreements, (iv) claims against third parties arising under the credit documents, (v) guaranties, collateral or other security supporting the loans, (vi) payments or other distributions under a restructuring or liquidation of the borrower, and (vii) the economic benefit of commitment reductions, repayments of principal or non-ordinary course fees received from and after the trade date.
- Seller makes extensive representations and warranties to purchaser, including:
 - i. Principal amount of loans— provides purchaser with recourse if the outstanding principal amount of the loans is less than seller represents;
 - ii. “No bad acts”— provides a purchaser with recourse if purchaser is treated less favorably than other lenders because of seller's prior acts, conduct or omissions as a lender;
 - iii. No notice of impairment— provides a purchaser with recourse if seller previously received written notice (which was not publicly available) that the loans could be void, unenforceable, or the subject of any other impairment; and
 - iv. Accuracy of chain of title— provides a purchaser assurance that all predecessor transfer agreements are included in the important bundle of ancillary rights that purchaser receives in addition to the loans. Purchaser is a beneficiary of a seller's rights under the predecessor transfer agreements, which can prove critical in maximizing the value of a distressed loan position.
- Seller holds purchaser harmless from any losses purchaser may incur arising from:
 - i. Disgorgement—any obligation to reimburse the borrower or any other entity for payments previously received seller. These “clawback” attempts often occur in a borrower's bankruptcy proceeding and can involve large amounts of cash or other property to be returned to the borrower's bankruptcy estate; and

- ii. Seller's status as an "insider" or "affiliate" of the borrower resulting in purchaser being treated less favorably than other similar situated lenders. This indemnity offers purchaser another form of protection against recharacterization risk and equitable subordination concerns.
- Voting rights—once a trade has settled, purchaser has sole authority to exercise all voting rights related to the loans and the transferred rights. If seller can exercise any voting right after the settlement date, then seller is obligated to follow purchaser's instructions (and this is not the case in a par/near par trade settled on an A&A). Lenders to distressed borrowers typically find themselves asked to make vital decisions regarding the future viability and structure of the borrower through any restructuring or reorganization process, which decision-making power can also be a valuable tool for purchasers in maximizing value of a distressed loan.

The wrap-around structure of the distressed PSA, used in the US secondary loan trading market, provides purchasers buying debt at a discount with expansive rights and claims in respect of the loans, assurances that their due diligence is correct, and market-tested protection against risks of equitable subordination/recharacterization, disgorgement and other possible impairments to the loans.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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