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CLIENT ALERT

Focus On Essentials When A Trade May Break

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The recent disruption to financial markets is putting new strains on the process of closing trades of syndicated bank loans, bankruptcy claims, restructured equity and other types of assets traded by participants in the secondary credit markets. Although this market has long abided by the convention that parties are bound when traders agree to the material terms of a trade—not when a trade closes—rapid price movement and liquidity constraints have dramatically increased the likelihood of broken trades. Delays in trade settlements have also proliferated in the absence of any specific time frame mandated by regulation or the Loan Syndications and Trading Association. In these extraordinary times, we recommend that market participants focus on the following key issues:

1. What trade terms are now "material"?

Although New York law enforces oral agreements to trade, it is essential that there be expressed agreement—a "meeting of the minds"—on all material trade terms. If there is no meeting of the minds on material terms, then there is no contract. For bank loans, it has long been the case that verbal or written agreement on purchase rate (price), identity, and purchase (face) amount forms a binding commitment to trade. For bankruptcy claims, other material terms may include whether guarantee claims are also being transferred, indemnification rights against the seller, and representations about the collateral securing the claim. Material terms for a trade of insurance subrogation claims may include whether the trade is for paid or unpaid claims and whether the purchaser is taking subordination risk. It is therefore important to pay careful attention to the asset being traded and surrounding circumstances.

2. How can I put teeth into an agreement for my counterparty to negotiate open terms?

Another essential ingredient for a binding trade is that the parties communicate an intent to be bound. New York law applies a "totality of the circumstances" test rather than a bright line rule. In the loan market, a trader's statement that "we're done" establishes an intent to be bound even though trade confirms commonly recite that the trade is "subject to" negotiation, execution and delivery of a final integrated agreement.

For bankruptcy claims trades and other bespoke transactions, transaction terms can sometimes be complex. Parties may reach agreement on some material terms, for example in an unsigned term sheet, but agree to leave other terms open for further negotiation. In such situations, communicating that an agreement is "subject to" a final writing may be fatal to a binding contract.

But New York law also recognizes that an agreement to negotiate—a so-called "Type II" preliminary agreement—is itself a binding commitment. Remedies for such agreements may be limited to reliance damages and out-of-pocket costs, such as fees and expenses incurred in negotiation. However, one New York court has suggested that a party may be able to seek an order directing the other party to conclude the trade (specific performance) or monetary damages for the lost benefit of the bargain (expectation damages) where the parties specifically promised that they "shall negotiate in good faith and with the intent and

design to conclude and sign" a final agreement. Parties interested in putting teeth in promises to negotiate open terms should consider using similar language.

3. Has the agreement been adequately documented?

Beyond proving contract formation, some written documentation of the trade may also be necessary to satisfy the New York Statute of Frauds. This is not an issue for bonds, equity and other types of securities due to a blanket exception to the Statute of Frauds. For loans and bankruptcy claims, however, there must be "sufficient evidence" of a contract. Such evidence may include e-mails, Bloomberg chats, trade recaps, telephone recordings or trade confirmations communicated by one party and not promptly objected to by the other. In times of market stress, non-defaulting parties will be in a better position to enforce trades if they have created a clear and specific record proving the material terms of the trade.

4. Is there risk associated with the seller's insolvency?

Rapid price declines have raised concerns that low-priced trades by potentially insolvent sellers could be subject to future claw-back actions under constructive fraudulent conveyance laws. One key issue will be whether fair value was paid for the asset. In this environment, establishing some record of fair market value at closing would be useful in defending against future creditor attacks. Buyers should seek to obtain representations regarding the seller's solvency and the fairness of the price paid. Buyers should also seek indemnification provisions that cover the costs associated with defending any potential claw-back actions.

5. Are the courts even open to enforce my rights?

The New York courts are understandably focused on dealing with the current public health crisis. In the immediate term, the likelihood of obtaining emergency interim relief for a commercial dispute—for example, to prevent a third party from buying an asset that a seller had already agreed to trade—is low. Indeed, the New York state court in Manhattan is presently not accepting any filings relating to financial markets disputes.

However, we expect that there will be an increase in broken trade claims as a result of the ongoing market disruption. Because asset prices are moving quickly, breach of contract damages from broken trades are likely to be higher—making it more worthwhile to litigate disputes. When a potential trade issue arises, therefore, we recommend that market participants proactively consult with counsel in advance to ensure that they can best protect their rights.

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