CLIENT ALERT

Par or Distressed – Who Decides?

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In today's global secondary loan market, negotiating trade terms is not usually a protracted process, but rather an efficient set of communications, where the parties reach agreement on only the most material trade terms and trust that market documentation frameworks and trading conventions will supply the remaining terms. Whether a trade will be documented as a "par" trade or a "distressed" trade, however, is one of the more important terms that is generally addressed in the earliest communications between the trading parties.

The distinction between trading on par or distressed terms is important. "Par" terms provide for a limited set of representations from the seller to the buyer concerning the loans being traded, whereas "Distressed" trading terms provide the buyer with an enhanced set of seller representations, warranties and indemnitees. Both the Loan Market Association ("LMA") in Europe, and The Loan Syndications and Trading Association ("LSTA") in the U.S. promulgate loan trading conventions and publish trading documentation covering both par and distressed trading situations. However, both trade associations rely on the loan sellers and buyers themselves to determine whether a particular loan should trade on par or distressed documentation. But how can such an important term be efficiently determined at the time of trade?

Historically, under both the LMA and LSTA frameworks, loan dealers would offer to sell a loan on distressed terms only after a significant number of their buy-side clients would demand distressed terms. There is always some pressure on dealers to close trades quickly. This may account for some of their resistance to trade on distressed terms, as they generally require a more thoughtful application of trading principles to specific distressed situations. Prior to the recent downturn, many buy-side funds were slow to demand distressed terms as the secondary loan market has been stable and/or rising for years. In many cases, this is the first period of market turbulence that analysts and traders have experienced. Given the current economic uncertainty, it would be prudent for buy-side funds to demand distressed terms and thereby gain the protections that this buyer-friendly documentation provides against the risk of impairment to the loans being purchased.

One key distinction between the LMA and LSTA frameworks is how each determines when a particular loan should trade on par or distressed documentation. The LSTA has adopted rules to determine the specific date that a loan shifts from trading par to trading distressed. This "Shift Date" is actually published by the LSTA for each loan, and is binding on market participants who agree to utilize the LSTA trading framework. As the seller only provides protections to the buyer under the LSTA distressed documentation for the period on and after the Shift Date, it is critical that the market agrees on a date certain for each distressed loan traded in the secondary market. Prior to the LSTA's introduction of the single, market-wide Shift Date, trading parties often spent a great deal of time and expense debating the appropriate date. Buying on par documentation after a date the rest of the market is already trading the loan on distressed documentation is especially risky for buyers because, they may then be required to provide "step-up" representations (i.e. representations regarding the conduct of its predecessor-in-title) for such perceived deficiencies subsequently reselling the position.

The LSTA's original method of determining a particular Shift Date was to poll a group of loan dealers, but was later determined by reviewing actual trading data. The Shift Date was always intended to establish "when" the market for a particular loan shifted from par to distressed, not "if" such a shift had already occurred. The LSTA anticipated that loan trading parties would continue to make such determination on their own, which the LSTA would monitor. However, when determining how to trade a loan, dealers began to point to the fact that the LSTA had not yet issued a Shift Date as a reason to continue trading the loan on par documentation. As a result, subsequent polls by the LSTA of those dealers would fail to uncover distressed trading and result in no perceived need to shift from par to distressed documentation. The circular nature of this dynamic often results in loans continuing to trade on par documentation until the borrower actually files for bankruptcy protection, notwithstanding that the LSTA distressed documents were designed to benefit buy-side investors far in advance of such an event.

In light of the added protections provided by the distressed documentation, buy-side investors should insist upon distressed documentation when purchasing a loan to a borrower that is financially stressed or distressed. Besides not getting the protections afforded by the distressed documentation, a buy-side investor that does not obtain distressed documentation may find it needs to provide step-up representations if it decides to sell such loan in the future. As the trading volume of stressed loans continues to rise, all buy-side investors should adopt a conservative outlook, seeking where appropriate to enhance their protections by trading loans on distressed terms.

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