

# New LSTA Par/Near Par Buy-In/Sell-Out Procedures

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The U.S. secondary bank loan market, like other credit markets, is undergoing a period of stress and the related re-examination of fundamental trading assumptions. While counterparties commit contractually to settle trades “as soon as practicable” and while “best practice” timeframes for trading par and distressed bank loans are widely published and discussed, in truth, the aspirations of market participants for prompt settlement are rarely met.

A contributing factor to delayed settlements has been that purchasers and sellers of par bank loans have typically had limited recourse against counterparties that fail to settle open trades in a timely manner. Except in rare cases, trade confirmations do not set a specific date by which the transaction is required to settle nor do they indicate that “time is of the essence”. Absent overt conduct demonstrating a non-performing counterparty’s unwillingness to proceed, a market participant would likely find it difficult to state a meritorious claim for breach of a trade confirmation on the sole grounds that its counterparty was slow to settle the transaction.

While The Loan Syndications and Trading Association, Inc.’s (the “LSTA”) Compensation for Delayed Settlement convention may help mitigate economic hardship, settlement delays frustrate the ability of the parties to obtain the full benefits of their bargain. In addition, during the often lengthy settlement period from trade date to trade settlement, the market price of the relevant loan may move in favor of the performing party, increasing its potential losses should the non-performing

counterparty become insolvent or otherwise default on the trade. In addition, if the non-performing party is the seller and the buyer has committed to resell the loan to a third-party purchaser, that third-party purchaser may also be harmed by the “upstream” settlement delay.

In order to reduce counterparty credit risk arising from extended settlement periods, the LSTA’s newly released (effective February 6, 2009) Standard Terms and Conditions for Par/Near Par Trade Confirmations (the “Standard Terms and Conditions”) include a new set of Buy-In/Sell-Out provisions (the “BISO Provisions”).<sup>1</sup> Designed by the LSTA to encourage timely settlement of par loan trades, the new BISO Provisions permit a party victimized by a procrastinating counterparty, under certain circumstances, to terminate its open trade and enter into a “cover” transaction with a third-party on the open market. The “nonperforming” party would then be responsible to indemnify the “performing” party from any market losses resulting from such substitute transaction.

In this memorandum, we will discuss (i) the applicability and design of the BISO Provisions, (ii) the market ills the BISO Provisions were designed to correct and their likely effectiveness in doing so, and (iii) the future implications of the BISO Provisions for the secondary par loan market.<sup>2</sup>

## I. BISO PROVISIONS

The BISO Provisions are automatically applicable to par/near par loan trades confirmed on LSTA terms on or after February 6, 2009. Trades already outstanding on that date continue to be

## Memorandum

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<sup>1</sup> The BISO Provisions are contained in Sections 16-19 of the Standard Terms and Conditions and are attached hereto as Exhibit A.

<sup>2</sup> This updated has been prepared as a service to clients and friends of Richards Kibbe & Orbe LLP to report on recent developments in the US secondary loan market that may be of interest to participants in that market. The information is therefore general and does not (i) constitute legal advice, or (ii) focus on issues relevant to specific facts and circumstances.

governed by the prior version of the LSTA Standard Terms and Conditions in existence on the applicable trade date, which version does not contain the BISO Provisions.<sup>3</sup>

**A. Applicability.**

The BISO Provisions are applicable to assignments only. They do not apply to transactions in which the parties have agreed on the trade date to settlement by participation or to transactions which, as a result of a failure to obtain necessary consents or to otherwise qualify for assignment under the applicable loan agreement, must be settled by participation. The BISO Provisions apply to par/near trades only; the new LSTA form of Distressed Standard Terms and Conditions does not contain similar provisions. Provided that they otherwise qualify, either a buyer or a seller may avail themselves of the benefit of the BISO Provisions, but not (for obvious reasons) both parties in respect of the same transaction. Use of the BISO Provisions is optional; a buyer or seller eligible to use the BISO Provisions may continue to push its counterparty to settle or it may avail itself of other available remedies under general contract law or otherwise.

If, after T+20 (the date that is twenty (20) business days from the applicable trade date), the transaction has not yet settled and one of the parties (the “Nonperforming Party”) has not yet delivered signed copies of the trade confirmation<sup>4</sup> and the form assignment and assumption agreement prescribed by the applicable loan agreement (the “Assignment”), then, provided that the other party (the “Performing Party”) has executed and delivered the trade confirmation and the Assignment, the Performing Party may deliver a written notice (the “BISO Notice”)<sup>5</sup> to the Nonperforming Party advising the Nonperforming Party of its intent to terminate its

obligations under the trade confirmation and effect a cover transaction. The Nonperforming Party then has a ten (10) business day period (the “Cure Period”) to cure such “default”, and thereby end the BISO process, by signing and delivering the Assignment and/or the trade confirmation to the Performing Party.<sup>6</sup>

If the Nonperforming Party fails to deliver the signed Assignment and/or the trade confirmation by the end of the Cure Period, the obligations of the parties under the trade confirmation are automatically terminated (subject to possible reinstatement, as described below). The Performing Party is then obligated to use reasonable commercial efforts to enter into a cover transaction with a third-party seller or buyer, as applicable. Once the cover transaction has been settled, the Nonperforming Party must reimburse the Performing Party for any loss suffered by the Nonperforming Party -- the difference between the cover price and the price payable under the original trade confirmation.<sup>7</sup> The Nonperforming Party may dispute the reasonableness of the cover price, with such dispute subject to binding arbitration before the LSTA. The BISO Provisions are of a “no fault” nature, however; having otherwise acted in good faith or without intent is not, in itself, a valid defense to a BISO Notice.

Finally, if the Performing Party fails to identify a substitute counterparty within the ten (10) business day period starting on the expiration of the Cure Period, the original trade confirmation and the obligations of the parties thereunder are automatically reinstated.

**B. The “BISO Shield”.**

Under certain circumstances, a seller accused of being a Nonperforming Party may assert a valid defense against a BISO Notice if it has engaged in an ordinary

<sup>3</sup> While the December 1, 2006 version of the LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations did contain Buy-In/Sell-Out provisions, because the provisions required the applicable BISO Notice to be sent only a few days after the trade date, they were of limited practical use.

<sup>4</sup> A question arises as to whether a Nonperforming Party that has not executed and delivered the trade confirmation is actually bound by the BISO Provisions in the first place. Arguably, to the extent the Nonperforming Party has agreed to “LSTA terms” prior to that time, the BISO Provisions do apply.

<sup>5</sup> In the form prescribed by the LSTA and attached hereto as Exhibit B.

<sup>6</sup> It should be noted that, to the extent the performing party is the seller, it must actually hold the specified loans as of the date of delivery of the BISO Notice.

<sup>7</sup> To the extent such difference is negative, however, the Performing Party must pay the resulting gain over to the Nonperforming Party.

course “riskless principal”<sup>8</sup> or similar trading practice (the “BISO Shield”). Upon receipt of the BISO Notice, the seller may, prior to the expiration of the Cure Period, deliver to the buyer/Performing Party a fully-executed copy of an unsettled trade confirmation or trade confirmations (with the purchase price and purchase rate redacted) proving the existence of the seller’s upstream buy-in.<sup>9</sup> The upstream confirmation (s) must have a trade date that is not later than the date that is five (5) business days after the trade date of the original transaction. Seller must also certify to buyer in writing that (i) such upstream confirmation has not been delivered previously and will not be delivered subsequently as a BISO Shield with respect to another transaction, (ii) the seller has performed and will continue to perform its obligations under the upstream confirmation, and (iii) if the upstream seller has not or does not perform its obligations under the upstream confirmation in a timely manner, the seller will deliver a BISO Notice to such upstream seller. To the extent that seller satisfies each of these requirements, buyer shall not be entitled to exercise any further rights as a Performing Party against seller under the BISO Provisions.

## **II. PAR/NEAR PAR SETTLEMENT SLOWDOWN**

Since the start of the credit crisis, the market has seen an unprecedented increase in average settlement times for par/near par bank loan transactions. The lengthening settlement times increase counterparty credit risk for open trade confirmations at a time of acute focus on counterparty risk in the credit markets. A number of factors have been cited for the settlement delays:

1. **Lack of Liquidity.** In many cases, buyers have simply been unable to settle their open trades in a timely manner due to their own financial condition. Well-publicized failures of major players in the bank loan market, such as Lehman Brothers and Bear

Stearns, as well as lesser known instances of funds simply delaying purchases as a tool to manage their own liquidity needs, have had a major effect on the speed and efficiency of the secondary loan trading markets. As discussed above, the failure of a single institution to timely settle a bank loan transaction can result in a domino-like failure of upstream and downstream transactions to settle as well.

**Effect of the BISO Provisions.** As drafted, the BISO Provisions could provide counterparties with a powerful tool to push for timely settlement. The threat of a BISO-caused trade termination could create the necessary leverage for the Performing Party to induce the Nonperforming Party to move forward with the transaction. Even if the Nonperforming Party fails to do so and the Performing Party triggers the BISO Provisions and enters into a cover transaction, at least the Performing Party will be able to acquire or dispose of the relevant inventory and fix its claim against the Nonperforming Party, mitigating against the risk of further loss resulting from market price volatility.

If the Nonperforming Party actually files for bankruptcy, however, the ability to take action in respect of a BISO Notice delivered prior to the petition date would be subject to the bankruptcy court’s “automatic stay” provisions and therefore would require court approval. Still, the Performing Party would be in no worse position that it would have been had it not sent the BISO Notice and, should the Nonperforming Party/debtor later “assume” the trade confirmation as an executory contract, it would likely have to do so subject to the continuation of the BISO process.

2. **Short-Selling.** As senior secured par bank loans have historically traded at levels at or near par, there has never been a strong economic motivation to short-sell par bank loans. Since the credit crunch, however, many such loans have traded at large discounts to par, with purchase rates falling, in certain cases, as low as

<sup>8</sup> “Riskless principal” refers to the practice, often employed by dealers, of intermediating a trade and taking title to the asset from an “upstream seller”, before passing title to a “downstream buyer”.

<sup>9</sup> The confidentiality provisions of the Standard Terms and Conditions have been amended to permit such disclosure.

30 – 40% of par. As a result, while no formal short-selling market exists under the current LSTA architecture, it is widely believed that many market participants have taken it upon themselves to short specific loans by entering into binding commitments to sell the loans while, at the time, having neither the inventory necessary to satisfy the sale commitment nor a binding commitment to acquire such inventory. When the short-seller feels that the market price has dropped sufficiently, it goes into the market and purchases loan inventory sufficient to cover its original sale. While this strategy may be profitable in a falling market, it may also result in substantial delays in the settlement of the original transaction. Again, this delay may have negative repercussions on the secondary trading market and its participants.

Effect of the BISO Provisions. While the BISO Provisions would not prevent short-selling, they would permit a Performing Party to effectively limit the short-sale period of its seller/short-seller. Entering into the cover transaction effectively terminates the short-sale and requires the short-seller to pay damages to the Performing Party resulting from any increase in the market price during this period. It is worth noting, however, that if the short-seller's view of the market was correct and the market price of the loan dropped, the BISO cover would, paradoxically, require the Performing Party to pay over to the short-seller its gain resulting from having effected the cover at a lower price. This would actually benefit the short-seller as it would no longer have to incur the trouble and expense of purchasing the loan to cover the short. It is an open question whether, under these circumstances, a Performing Party purchaser would decide to send the BISO Notice in the first place, although they may do so if they need to otherwise obtain a long position in the loan.

**3. Increased Credit Scrutiny, Administrative Agent Slow-down.** Since the start of the credit crunch, both administrative agents and borrowers have tightened standards of creditworthiness for new lenders in their loan facilities. The higher standards

and increased scrutiny has resulted in the rejection of many prospective purchasers into these loans facilities as well as an increase in the amount of time taken to conduct credit reviews. Post-trade date diligence of counterparty creditworthiness has also increased. In addition, recessionary pressures have led to workforce reductions at many of the administrative agent banks. Fewer or less-experienced personnel may have made it more difficult for the administrative agents to process trades on a timely basis. These delays have contributed to the overall slowdown in the settlement process.

Effect of the BISO Provisions. Because the BISO Provisions do not eliminate the necessity to settle the relevant loan transactions they will not provide relief for settlement delays resulting from the agents' and borrowers' need for increased scrutiny of prospective lender creditworthiness or operational workforce reductions. In fact, these systematic delays would presumably serve to slow down the settlement process for the cover transaction as well, possibly making the BISO process less appealing for a Performing Party.

### **III. IMPLICATION OF THE BISO PROVISIONS**

Time will tell how often the BISO Provisions are actually used by Performing Parties to speed closing of their aged par/near par loan transactions. While the BISO Provisions do permit a Performing Party to terminate an outstanding aged transaction, they do not allow such party to escape its obligations with respect to an economically unfavorable trade, as the terminating party is still required to make the Nonperforming Party whole. In addition, the Performing Party is still required to go through the trouble of executing and settling a trade with a new counterparty, further delaying the trade settlement process. Coupling that with the general ill will likely generated by sending a BISO Notice to a counterparty, it is hard to imagine that the BISO Provisions will be used other than under the most extreme of circumstances: for very old trades or against

counterparties operating under a cloud of heightened insolvency or performance risk.

Presumably, dealers who are unable to settle sale transactions as a result of nonperforming upstream sellers will avail themselves of the BISO Shield to avoid being required to later purchase inventory for which they no longer have a downstream buyer. In fact, the BISO Shield could eliminate much of the utility that the BISO Provisions would have otherwise provided to end-buyers anxiously awaiting the settlement of their transactions from dealers.

For parties without the ability to use the BISO Shield, unsettled chains of par loan transactions, each triggering cascading BISO Provisions, could conceivably result in multiple parties in the same chain simultaneously seeking to cover their transactions.

The unfettered use of the BISO Provisions likely would result in short-term market chaos, as the market is currently unaccustomed to sending the requisite notices and meeting the various timing and other requirements of BISO procedures. In addition, such unchecked use could create a new category of trade disputes as counterparties argue whether the criteria for using the BISO Provisions have been met and whether the prices of the cover transactions are fair. To the extent the BISO Provisions are used prudently and sparingly, however, they may turn out to be a good, if incremental, solution to the risk of backlogged problem trades.

If you would like more information on the BISO Provisions or have any questions on the current issues in the U.S. secondary loan market, please feel free to call us at 212-530-1800.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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