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Claims Trading –
Basic Building Blocks &
Beyond

Outline of Presentation

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General Overview – What am I Buying?

- Basic understanding of Claims Trading - Focus on Allocating Risk
- Unlike Bonds and Bank Debt, there is more risk and different types of risk in trading claims– Markets recognize this by pricing claims that are *pari passu* below bonds and bank debt
- In Chapter 11 cases, a “Claim” is any right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured
- What am I buying – basics:
 - Typically, a Buyer purchases only the right to payment on a claim and does not assume any obligations
 - Which Debtor is the Claim against?
 - What is the amount of the Claim? (This may not be certain)
 - What is the priority of the Claim? -Typically General Unsecured
 - US or Foreign Bankruptcy/Insolvency Proceedings

Types of "Claims"

- Traditional "Trade Claims"
 - Claims against a debtor held by a creditor arising from supplying goods or services, e.g., vendor, supplier, service provider
 - Administrative Expense claims – 503(b)(9)
- Non-Financial Contract Claims
 - Deficiency Claims - under-collateralized portion of a secured claim
 - Claims arising from renegotiation or rejection of a lease - debtor's rejection of pre-petition lease agreements (AMR)
- Financial Contract Claims
 - Claims arising out of terminated financial contracts or custody accounts, e.g. derivative claims (pursuant to an ISDA and/or secured on a *pari passu* basis with loans made to the debtor under a credit agreement), prime brokerage, forward contracts, securities lending, and repurchase transactions (LBSF, LBCS, GGP, ITR)
 - Can often include transaction-specific Guaranty Claims (LBHI, AMR)

Types of "Claims"? (Cont'd)

- Customer Accounts/SIPA:
 - Prime brokerage (LBIE, LBI and Madoff)
- Notes and Bonds/Loans
 - Lehman Program Securities; Icelandic Bond Claims
 - Guaranty claims in US -- "Cleary Form"
 - Bilateral Credit Agreements (Lehman/Asia claim)

Different types of "Claims" have different supporting documents and different types of counterparty – all of which result in different risks and costs for market participants

Chapter 11: A Typical Timeline

Typical Chapter 11 Timeline

- Restructuring Support Agreement (Pre-Petition)
- Debtor files Chapter 11 (Petition Date) –Automatic Stay
- Claims agent appointed
- Debtor files Schedule of Liabilities (subject to amendment) & SOFA -- if not listed on schedule as C, U or D, this serves as prima facie evidence that claim is allowed, BUT may be amended at any time - This is the amount debtor believes it owes creditor
- Claims Bar Date(s) set by Court
- Creditors file Proofs of Claim – POC is where most of the diligence material can be found –this is the amount creditor believes it is owed by debtor
- Claims reconciliation process – objections to claims (typically post-confirmation) – if Scheduled amount is less than POC amount, expect an objection
- Plan and Disclosure statement proposed
- Plan vote/confirmation
- Plan distributions to allowed claims– may be series of distributions over time

Goal of Buyer and Seller

- Goal of Seller is to monetize claim as soon as possible without any trailing liability or contingencies
- Goal of Buyer is to buy an allowed claim – a claim with certainty as to validity and amount. A claim entitling Buyer to pro rata distributions
- Buyers balance opportunity cost against risk of buying a bad claim
- Allowed by Order (Final Non-appealable)
 - Allowed claims may be subject to avoidance – setoff, preference, etc.
 - Allowance Order may have terms/conditions and continuing obligations
 - Stipulated as allowed pursuant to settlement procedure order (e.g. AMR and Lehman ISDA claims below a certain dollar amount where settled by a Court ordered procedure) - same concerns as above
 - POC timely filed – deemed allowed unless objected to by a party in interest by objection deadline often set in Confirmation Order
 - Review Schedules & SOFA. If “Scheduled” in different amount or as C, U or D, POC is likely to receive objection
 - 502(d) issues - Enron v. KB Toys – (Assignment v. Sale → Does Disability Travel with Claim)

Objections to Claims

- Claim Objections: Any party in interest may object to a claim
 - Typically the Debtor objects but any party in interest has standing to object
 - An objection to a claim may be raised up until, and in some instances after, Plan confirmation, depending on the provisions of a Plan's claim resolution procedures.
 - An objection may be resolved by a negotiated settlement, subject to Court approval or as determined by the Court
 - Issue: After the sale of a claim, will Buyer or Seller control the defense of the claim and who will bear fees and costs?
 - Vote Designation Cases (DBSD)

Risks and Costs of Purchasing Claims vs. Bonds and Bank Debt

- Credit Risk of Debtor: All have risk that Debtor's estate will not be able to repay the claim. That is credit risk as opposed to quality risk.
- Quality Risk: Validity and amount of claims are commonly challenged, as opposed to bank debt and bonds (which are typically fixed and liquidated claims).
- Counterparty Risk: *Quality Risk leads to counterparty risk*. Unlike bonds and bank debt, Original Claim Sellers are not typical market participants. Dealers are more likely to pass through CP risk.
- Diligence Risk/Costs: Each claim arises from separate set of documents with a claim filed by each individual claimant. Documents giving rise to each claim must be reviewed. Bank Debt has one credit agreement; Bonds one indenture.
- Transfer Risk/Costs: Claims use non-standard or customized documents, varied trading conventions, and have procedural transfer issues.

Key Diligence items/concerns

- Why do we diligence a claim – determine quality risk which can then be allocated in Claim Purchase Agreement.
 - Review of Schedules & SOFA (502(d) risk)
 - Was POC “timely” filed pursuant to Bar Order?
 - Is the amount and priority correct?
 - With sufficient supporting documentation?
 - Against the correct Debtor/Case?
 - Were principal, interest and default interest claimed? (GGP example)
 - What is the current status of the claim?
 - Record Ownership as evidenced by Claims Register?
 - Review of claim settlement agreement – were Court procedures followed.
 - Were contract procedures for establishing the claim properly delivered and the claim amount properly calculated and evidenced? (ISDA example - Metavante)
 - All documents fully executed? Is there a signed guarantee?
 - Lien Search performed?
 - Subject to objection, defense or avoidance? Has such risk passed?

Terms of Trade – Trade Confirmation

- Balance: Goal of Buyer – lock up claim while performing diligence and allocating risk -- vs. -- Goal of Seller to have Buyer commit to buying claim as soon as possible with no contingencies.
- Oral, e-mail, text, Bloomberg communications – create binding agreement? (NY SOF & Highland/Kingate/High River cases)
- Diligence
 - Diligence before trade vs. trade subject to diligence. Supporting documents, review docket, upstream documents, settlement agreements
 - Auctions (Common for Large Claims; Limited Negotiability)
- NDA (LSTA form)
- U.S. Style vs. LMA Style?
- Specific Terms of Trade (Voting Rights? Information Rights?)
- Is Seller the original clamant or is this secondary trade?
- Recourse vs. Non-recourse? If recourse, who is recourse against?

Terms of Trade – Trade Confirmation (cont'd.)

- Assignment vs. Participation (or Sub-participation)
- Typical provisions incorporated into a trade confirm:
 - Description of the purchased asset (debtor/case and type of claim)
 - Claim amount and purchase rate
 - Confidentiality, non-reliance, no shop provision
 - Subject to delivery of supporting claim documents and satisfactory diligence review by the Buyer
 - Subject to negotiation of a mutually agreeable documentation
- Trade Confirmations are non-standard and should be reviewed by counsel prior to execution
 - LSTA published draft claim trade confirmation in Oct 2013

U.S. Style v. LMA Style

Issues and Nuances:

- U.S. Style v. LMA Style
 - (Pros v. Cons – Sell Side v. Buy Side Perspective)
- LMA documents have predecessor in title representations (which may address credit risk concerns, if buying from a dealer)
 - o any supplemental trade specific terms regarding the insolvency proceeding
 - o any modifications to standard terms
 - o voting/information rights (no voting or information rights in LMA Confirm)
- U.S. Style documents provide recourse typically up the chain of title to original Seller (allows for pass through of risk by market maker)
 - Due to lack of standardization, upstream documents may be unacceptable and step ups may not be able to address the deficiencies

Addressing Risk – Claim Purchase Agreement

- If a claim is not clearly allowed, there are three basic types of agreements that allocate between Buyer and Seller the risk of the claim being allowed:
 - “As-Is” - Allocates all risk to Buyer
 - “Recourse” – liquidate damages if claim is “disallowed” - typically return of purchase price on portion of claim disallowed plus interest
 - o The “recourse” trigger is the definition of “disallowance” – i.e., can be mere objection (Longacre case)
 - o If Seller is secondary holder (i.e., dealer that previously purchased), is “recourse” to dealer for spread only or full purchase rate?
 - o Cure periods, options and timing can be built into “recourse” provisions (i.e., 90 days to cure)
 - o Some Sellers will not agree to recourse provisions (typically in auctions/stipulated allowed claims)
 - o LMA documents typically do not include “recourse”
 - “Non-Recourse” –Allocates risk to Seller via representations and warranties. Buyer must prove damages.

Addressing Risk – Claim Purchase Agreement (Cont'd.)

- Quality Risk is addressed via representation and warranties, covenants and other provisions.
 - Allowed Claim; Claim Amount; Case; No Bad Acts; No Impairment; No Preference; Document Delivery; POC representation; No other documents;
 - Covenants: Bad Acts, compliance with supporting documents and settlement agreements, Claim and case specific.
 - Voting and Other Acts and Decisions - Who controls?
 - Indemnification
 - Protection from bad act of other claim holders - Lehman Settlement Agreement
 - Skin in Game
 - Seller First Loss

Acts and Decisions/Power of Attorney

- Issue: Who has right to settle claims or defend against objections?
- Claims are often reduced via objection and/or settlement negotiation with the Debtor
 - The Claim Purchase Agreement should address whether Buyer or Seller controls such right to negotiate and settle the claim
 - Buyers want this to be a right, not an obligation.
 - Who bears legal fees and other costs related to defending objections or settling the claim?
 - Document should address whether such reductions will affect Buyer's right to "recourse" → does AOC allow Buyer "recourse" for amount of claim disallowed via settlement.
 - Buyer may be required to obtain Seller's consent prior to settling the claim (particularly if recourse triggered by such settlement).
 - Who has right to settle claim if claim held by several parties?
 - Sellers may want to participate until the claim is settled (control the settlement), then assign after the claim is settled
 - Seller further assurance to maximize amount of claim in minimum time.
- Will documents require Seller to notify Buyer of communications it receives with respect to the claim?
- Buyer would want the right to vote on the plan even if the record date has passed.

Purchase Price – Escrow and Holdback

- Typically Purchase Rate multiplied by Claim Amount – Flat (all distributions from and after trade date to Buyer)
 - Separate purchase rates for different claims (e.g., guarantee claim and underlying claim in Lehman)
 - Compensation for delayed settlement - not typical
 - Treatment of accrued interest/post-petition interest (if any) (AMR)
 - Understand currency conversions in the case (i.e. LBHI and LBSF may have different conversion rates so different USD claim amounts on Guaranty claim)
- A “recourse” provision and representations and indemnities are only as strong as the Seller’s credit (KB Toys)
 - Purchase Price can be used to allocate Seller counterparty risk.
- Purchase Price Holdback or Escrow (if it is not a settled claim, escrow/holdback and/or a “recourse” provision?)
 - Trigger for releasing Escrow or Holdback amounts

Post Closing Matters

- Filing 3001(e) or other notices of transfer – become record holder and receive notices and distributions
 - Notices in foreign jurisdictions
- Objections
- Distributions - how to track

Non-US Claims

- Insolvency laws and procedures are different in different countries (collateral perfection, stamp tax, withholding concerns, etc.)
- US is set up for transferring claims by Rule 3001(e) and scheduling Claims as allowed. Foreign insolvency laws do not have similar rules and are more *ad hoc*.
 - Process is less transparent (no public claims register or access to Proof of Debt, etc.)
 - Diligence can be difficult; Foreign Counsel Involvement

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