

## Secondary Loan Trading Considerations in a COVID-19 World

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The COVID-19 pandemic has triggered an abrupt end to the bull market across most asset classes. However, where there is risk, there is opportunity and we expect secondary loan market volumes to increase. In this advisory, Katten explores some key trading considerations for secondary loan market participants in a volatile trading environment.

### Falling Prices on Secondary Loans

There is no bright-line test to determine whether a particular loan will trade on par or distressed documentation. Investors typically evaluate the risk of default when making the business decision to trade par or distressed, with price being one of a number of factors. While the recent trend has been for credits to remain at par until the borrower files for bankruptcy protection, that convention is likely to change in the coming months.

### The LSTA “Shift Date” and Why It Matters

Market participants will often look to the Loan Syndications and Trading Association (LSTA) to determine an official date that a credit moves from par to distressed. The LSTA website publishes “shift dates” for its members based upon polling data from broker-dealers. Note that, in some instances, the poll may be inconclusive and, in other instances, the published shift date may precede the date of the poll itself. While we continue to see a high volume of par trades at historically low prices for par loans, we also have seen a slight uptick in the publication of shift dates by the LSTA. For the first quarter of 2020, the LSTA published shift dates for seven credits; since the start of the second quarter (through April 17, 2020), there are already five.

Where there are concerns about borrower instability, whether due to an unhealthy industry sector, a ratings downgrade in another asset class or general negative market conditions, market participants may request an LSTA shift date poll even in the absence of a payment default. However, the shift date poll takes time and can be unpredictable. A trader tasked with making an immediate decision regarding the proper LSTA trading convention may not have time to wait for the results of a shift date poll to be posted.

Why does the shift date matter? When a buyer settles a par trade after the LSTA shift date and subsequently transfers those loans on distressed documentation, that buyer will be expected to provide “step up” distressed representations and warranties to its downstream buyer. Step up representations speak not only to the seller’s own status, action or inaction, but also to the status, action or inaction of covered prior sellers (i.e., all prior sellers that transferred the loans on par documents on or after the shift date). Note that the step-up requirements relate to the **settlement date** of the upstream loans; the fact that the market convention was par at the **trade date** of the prior trade is irrelevant. One can see the potential issues that may arise in times of market instability and fast-moving credit risk.

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## Distressed Documentation Protections

In addition to mitigating against the step-up risk outlined above, the LSTA distressed trade documentation offers additional protections. Unlike par trades that settle via an assignment agreement in the form prescribed in the credit agreement, distressed trades include an additional LSTA document, the Purchase and Sale Agreement (PSA). The PSA allocates risk between a buyer and seller through additional representations, warranties and indemnities.

The PSA includes a basket of seller representations and warranties for the benefit of the buyer as well as an opportunity for both parties to include credit-specific language and protections as additional terms. Key seller distressed representations include no bad acts or omissions, no actual or threatened proceedings, no set-off, no preference actions, and a representation that the seller is not a party to any agreement that adversely affects the loans; a par seller only provides a representation as to clean title. The PSA also includes expanded indemnity rights. A distressed buyer is provided an opportunity to diligence predecessor transfer agreements and seek recourse not only against its immediate seller, but against all upstream sellers in the chain of title.

In the current environment credits can quickly transition from relative stability to default or bankruptcy between trade date and settlement date; a typical 90-day period between interest payments may be accompanied by a substantial change in credit risk. Notably, sellers and buyers may document in the PSA an agreement made between the parties at the time of trade to address potential lender actions regarding forbearance, plan support and DIP subscriptions, among others, and the rights of each party to direct such actions.

## The Bottom Line

Given extreme market volatility, increased pressure on borrowers and unknown commercial consequences of the COVID-19 pandemic, market participants should carefully evaluate the risks of settling trades on par documentation and consider whether the circumstances warrant a shift to distressed in anticipation of a borrower default.

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