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Communicating Intent inTrading Documentation: Lessons from *Stonehill*

An important decision related to the trading of bank loans was issued recently by New York State's highest court. **To the relief of the loan trading market, the decision reaffirms market practice surrounding the formation of binding obligations to close a trade.**

In *Stonehill Capital Management et al v. Bank of the West*, the New York Court of Appeals unanimously ruled that when a party enters into an agreement that is "subject to documentation," the party still has a binding agreement to settle the trade as long as the totality of circumstances indicates that the parties intended to be bound to a transaction.

Because the purchase of loans is a core component of many turnaround strategies, this ruling is of great interest to turnaround professionals and investors in distressed loans. Additionally, this case establishes that documentation between parties and even internal communications may be used as evidence to prove parties' intent and, therefore, also demonstrates the importance of being careful with such communications. Particularly with regard to trade claims, parties should use this case as reason to more clearly state that they intend to have a binding obligation.

Loan, Claims Trading Practices

Most syndicated corporate loans issued in the United States are traded under procedures and with forms issued by the Loan Syndications and Trading Association (LSTA).

The LSTA is a not-for-profit industry organization that works to increase the efficiency of the market for syndicated loans. The LSTA publishes standard trading documents for both par and distressed loans that are used in almost all domestic syndicated loan trades. These form documents are rarely heavily negotiated and have been instrumental in creating market efficiency and transparency.

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Most trades of secondary loans are made either directly between buyers and sellers or through one of a number of broker-dealers who "make a market" in trading these loans. A relatively small percentage of loans are sold via an auction process. Auctions are much more common for other, less liquid credit assets than they are for syndicated loans.

Loan trades are typically agreed to over the phone, with written confirmation of the key terms of the trade then made through email or another type of electronic messenger. After the trade is agreed to, the parties exchange a trade confirmation, which is followed by final trade documents. For par trades the suggested closing time is seven business days, and for distressed trades it is 20 business days.

The loan market has traditionally worked under the presumption that oral trades are binding obligations. This presumption was reinforced in 2002 when the New York Statute of Frauds was revised to specifically include loan trades as a type of qualified financial transaction for which an oral agreement is enforceable if certain conditions are met. Indeed, the liquidity of the loan market results largely from the fact that parties can verbally agree to a trade and immediately establish a binding obligation.

Bankruptcy claims are traded in a similar manner to loans, with parties agreeing to the trade through email or other electronic confirmation, which is then followed by definitive documentation. Trade confirmations are used in some but not all trade claim transactions. There are no industry standard form documents for trade claims in the United States. However, the LSTA has issued a form of trade confirmation but it has yet to gain wide acceptance, and there are widely used templates of assignment agreements for trade claims. Typically, only a handful of key issues are negotiated on standard transfers of trade claims.

The *Stonehill* Dispute

The dispute between Stonehill and Bank of the West (BOTW) dates to March 2012, when the bank owned a number of nonperforming mortgages and other loans that it was interested in selling through an auction. BOTW and Mission Capital Advisors LLC (Mission), the bank's financial advisors, set up a sealed-bid online competitive auction process whereby interested parties were invited to submit final, noncontingent offers for the purchase of any or a combination of the loans being offered by BOTW.

One of the loans included in the auction, a syndicated loan consisting primarily of mortgage loans with an outstanding principal amount due of nearly $8.8 million, was referred to by the parties as the Goett loan. The memorandum explaining the terms of the auction stipulated that "the acceptance of which by Seller will require immediate execution of pre-negotiated Asset Sale Agreement(s) by Prospective Bidder accompanied by a 10% non-refundable wire funds deposit." The seller also reserved the right, by its sole discretion, to withdraw any asset from the auction at any time.

Stonehill, a credit fund that invests in the equity and credit markets, indicated to Mission that it was interested in purchasing the Goett loan. A few days later, on April 18, Stonehill submitted a final bid to purchase the Goett loan for about $2.4 million. Over the next 10 days the parties, via their counsel, exchanged multiple emails related to finalizing the documents and effectuating the transfer. However, the documents were not yet finalized or signed, nor was any deposit yet paid. Then, for a few weeks, Mission and BOTW stopped communicating with Stonehill about the trade.

While the parties were finalizing the transfer documents, BOTW became aware that the Goett loan might be refinanced in an amount greater than the amount for which it had contracted to sell the loan to Stonehill. It would later be revealed that there were internal communications at BOTW debating whether, in light of the potential refinancing, the bank should close the sale to Stonehill. The internal documents did not mention any disagreement about documentation or other terms of trade. Finally, on May 25 Mission communicated to Stonehill that the bank would not be proceeding with the trade. Shortly afterward, on June 21, BOTW received about $4.2 million for the Goett loan through a refinancing, about $1.8 million more than it would have received had it sold the loan to Stonehill.

Stonehill then sued BOTW and Mission for breach of contract, among other claims. The New York Supreme Court, which is the trial court in New York, granted summary judgment to Stonehill for breach of contract, ruling that BOTW's acceptance of the bid created a binding contractual obligation to sell the Goett loan to Stonehill. Then, in a move that shocked the loan market, the New York Appellate Division overturned the New York Supreme Court and granted summary judgment to BOTW, determining that there was no binding contract between the bank and Stonehill because the agreement was "subject to documentation" and therefore was not a binding contract.

Finally, almost five years after the trade was entered into, the highest court in New York, the Court of Appeals, in December 2016 ruled in favor of Stonehill and reinstated the trial court's grant of summary judgment in the firm's favor. In an extensive ruling, the Court of Appeals found that, based on the totality of the communications between the parties, BOTW had a binding contract to sell the Goett loan to Stonehill. In February 2017, BOTW paid the judgment amount to Stonehill to close the matter.

Avoiding Ambiguity

Though *Stonehill* dealt with a syndicated loan sold in auction, its lessons are applicable to all secondary loan and claim trades. It may be that this case is even more applicable to non-auction trades, since the fast pace and often informal negotiations of such transactions can lead to the inclusion of ambiguous language in both internal communications and the document used to confirm the transaction.

Particularly with trade claims transactions, for which there are often a number of points that need to be negotiated and no standard form, parties need to be careful if they want to have a binding transaction prior to closing of a trade. Issues to keep in mind include:

- *Differentiate between conditions precedent to close a trade and those precedent to the formation of a contract to sell.*

  In the *Stonehill* case, BOTW claimed that it wasn't bound to agree to the trade until the conditions for closing set forth in the memorandum circulated prior to the auction—that is, the signing of closing documents and the payment of a 10 percent deposit—were met. However, the court ruled that though these were conditions for closing the trade, they were not conditions for establishing a binding obligation to close the trade. Rather, BOTW became bound to close the trade when it accepted Stonehill's bid, as a binding contract. If parties intend for the formation of a binding agreement to be considered contingent upon certain conditions being met, those conditions and that contingency must be explicitly stated in all communications and documentation that establish a trade, whether the trade is made via auction or directly between two parties.

- *Clearly and specifically state any rights of seller to withdraw from a trade or auction.*

  Because the auction documents in Stonehill permitted BOTW to withdraw the assets for sale at any time, BOTW argued that this allowed the bank to back out of its agreement to sell the loan at any time, possibly up until closing. A seller that does not want to be obligated to close a trade until documents are signed or until a deposit is paid needs to state this in the auction memorandum, trade confirmation, and any other potentially binding documents.

  It is advisable for both sellers and bidders to review their offer and acceptance terms with counsel prior to sending them to be sure that the terms are not ambiguous.

- *Do not conflate "subject to documentation" with "subject to negotiation" or "subject to diligence."*

  The court found that saying that a trade is "subject to documentation" is too vague to indicate that the agreement is nonbinding. However, saying that the trade is "subject to diligence" or "subject to negotiation," common phrases in the loan market, may have the opposite effect. It is likely that if the words "negotiation" or "diligence" had been used, the court would have found that there was not a definite intent to have a trade. The careful use of these terms is particularly

relevant with regard to assets such as trade claims, for which there is no standard LSTA form as there is for loan trades.

- *Be careful with internal communications. The old saying, "If you don't want to see something published in The New York Times, don't write it down," applies in loan trading transactions as well.*

  The court was influenced significantly by the internal communications of BOTW debating whether to break the trade over the financing terms, which appeared to acknowledge that there was a commitment to sell the loans. Given the common use of recorded lines, parties should be careful what they say on the phone as well.

An Important Victory

The *Stonehill* case is an important victory in affirming the current trading practices of the loan market. If the appellate court ruling in favor of BOTW had been allowed to stand, the market presumptions of binding trades would have left in significant doubt, which potentially would have been a marked blow to the liquidity of the secondary market for syndicated loans and claims and could have drastically changed the way secondary loan and claim trades are agreed to.

Credit is due to Stonehill, its investors, and counsel for persevering to see this case through to its conclusion, as well as to the LSTA for supporting Stonehill through the filing of an amicus brief in support of the loan market. It is important, though, that loan market participants don't rely too heavily on this ruling. Rather, parties involved in loan and claim trades should learn from this case to document such transactions with greater clarity and to communicate their intentions with greater care.

Polsinelli Loan and Claims Trading Practice

The Secondary Debt and Claims Trading lawyers at Polsinelli combine a deep knowledge of the secondary trading market with an appreciation of our clients' business needs. We work with both buy-side and sell-side clients, including CLOs, hedge funds, broker dealers and investment banks, to help them meet their objectives in a timely and cost-effective manner. Our team of lawyers and dedicated legal assistants has significant experience with Loan Market Association (LMA) and Loan Syndications and Trading Association (LSTA) documents, as well as trade claims, bilateral loans, and other types of illiquid assets.

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