

Clients & Friends Alert

CODERE S.A. SURETY BONDS – GAMBLING WITH UNFUNDED COMMITMENTS

25 February 2016

Mr Justice Robin Knowles CBE handed down his judgment on **29 January 2016** in **GSO Credit – A Partners L.P. (and other GSO funds) v Barclays Bank PLC and HCC International Company PLC [2016] EWHC 146 (Comm)** concerning the application of the Loan Market Association (“LMA”) Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims) dated 14 May 2012¹ (the “Terms and Conditions”) (as in effect on the Trade Dates of 10 and 11 June 2013).

The case provides the first judgment in the new Financial List that was established in October 2015 to facilitate the hearing of complex financial claims² by judges with relevant experience given the need for specialist expertise in the various litigations arising since the 2008 financial crisis.

The LMA trading documentation is widely relied upon by loan investors in the secondary markets in Europe, and loans to non-U.S. borrowers are regularly traded under the LMA standard terms. The judgment could have therefore resulted in significant consequences for traders had it not confirmed the market view of the treatment of “Purchased Assets” between the Seller and Buyer where a portion or all of the assets may be “unfunded” at the settlement date.

Background

HCC International Insurance Company PLC (“HCC”) was the issuer of surety bonds, defined as “a guarantee, indemnity, performance bond, surety bond, documentary credit or other instrument of suretyship...” to certain public authorities in Spain and Italy in connection with the performance of certain obligations of Codere S.A. (“Codere”), a gaming company.

¹ The LMA Standard Terms and Conditions have since been updated on 3 March 2014, 17 February 2015 and 16 December 2015.

² Fixed income, equity, derivatives, loans, FX and commodities markets, banking transactions and sovereign debt.

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HCC had contractual recourse to Codere in connection with the surety bonds under the terms of a Senior Facility Agreement dated 19 October 2007 (the “SFA”) and in particular, the Surety Bonds Facility. The Surety Bonds Facility was capable of being drawn by Codere by requesting that HCC issue surety bonds to certain public authorities, and to the extent any payment was made by HCC under the bonds, Codere was obliged to pay HCC. The surety bonds were issued as separate contractual obligations from HCC to the relevant beneficiaries of the bonds. By 7 June 2013, HCC’s maximum liability to the authorities under the surety bonds it had issued was around EUR23m, but no amounts had been called or paid to beneficiaries (i.e. the Surety Bonds Facility had been drawn by way of the issuance of bonds, but no payment had been made to any authority).

Back-to-Back Trade Transactions

GSO entered into agreements to purchase the Surety Bonds Facility from Barclays Bank PLC (“Barclays”), who acted as the intermediary broker and agreed, on a back-to-back basis, to buy the EUR23m Codere position from HCC on 7 June 2013. The purchase rate between GSO and Barclays was 77.125 %, and 76% between Barclays and HCC.

At the time of trade, the bonds were issued, but no demand had been made for payment by any beneficiary, and therefore the bonds represented an unfunded commitment of HCC.

When the parties came to settle the transactions, a dispute arose as to the amount payable between the parties and the subject matter of the trades.

In particular, HCC understood that the agreement was to purchase only HCC’s rights in relation to payments owed to HCC from Codere under the Surety Bonds Facility, and not the corresponding contingent obligations of HCC to fund the public authority beneficiaries under the bonds.

GSO however, expected payment to be made to it from the seller, on the basis that the burden of any payments under the issued surety bonds would ultimately be its responsibility and not HCC’s. On that analysis, around EUR5.4m was due to GSO from Barclays, and EUR5.7m due to Barclays from HCC (i.e. the Seller pays the Buyer in consideration for the Buyer’s acquisition of the unfunded commitment to fund a third party).

Key Facts

HCC argued that the assets sold only included HCC’s reimbursement rights under the SFA, and not its obligation to make payments to any beneficiaries under the bonds³. HCC contended that pursuant to the 2012 LMA Terms and Conditions, “Purchased Assets” excluded

³ HCC argued, amongst other things, that the purchased assets could not have intended to include the surety bonds, as the issuer had to meet certain eligibility criteria, and as such the bonds were incapable of direct transfer to Barclays and/or GSO.

“Purchased Obligations”. Furthermore, HCC contended, for the purposes of calculating the “Settlement Amount”, the bonds were “funded” because they were drawn under the SFA⁴. As a result, HCC contended that it did not owe Barclays (and ultimately GSO), but that Barclays owed HCC around EUR18m, and EUR18.3m would be due from GSO to Barclays.

GSO’s counter-argument was that the “Purchased Assets” included all of HCC’s rights and obligations under the bonds, as well as the Surety Bonding Facility, including the obligation to make any future payment to the beneficiaries⁵. GSO argued that a distinction needs to be made between “funded” and “drawn” and explained that whilst the bonds were drawn, they remained unfunded, since no payment had yet been made by HCC. Therefore, pursuant to condition 14 of the LMA 2012 Terms and Conditions, GSO contended that HCC owed GSO payment for the unfunded portion.

Judgment

The Court found in favour of GSO.

Mr Justice Knowles drew two key conclusions in his judgment:

- (i) *“the trade will, generally speaking, include the economic burden of the seller’s obligations under issued surety bonds;*
- (ii) *“Purchased Assets”[as defined in the Terms and Conditions] are generally ‘funded’ to the extent that the money has been paid by the seller under the issued surety bonds, rather than to the extent by which the facility has been drawn by the mere issue of the surety bonds”⁶.*

The purchase by GSO did therefore include the contingent obligation of HCC to make payments under the bonds, as well as its rights under the SFA. GSO was entitled to receive payment from Barclays/HCC in connection with the purchase of the rights and the unfunded obligations in relation to the LMA trade transactions.

The judgment also provides some comfort to brokers who enter into trade transaction on a “back-to-back” basis that the Confirmations should be construed and given effect to consistently (this was not in dispute here).

⁴ Judgment, para. 70 “Funded” and “Unfunded”.

⁵ This was substantiated with reference to the LMA 2012 User Guide, paragraph 6.2(a)(xviii) “Purchased Assets are defined to mean (a) the rights included with the traded portion of the relevant asset, but subject to the obligations and liabilities of the Seller attributable to the traded portion...”

⁶ Judgment, Conclusion para. 91, (a) and (b).

Conclusion

The Judgment provides a salutary reminder that the LMA standard terms and conditions are intended to be merely a starting point for negotiation only. The nature of the underlying Credit Documentation or the circumstances surrounding the borrower (particularly if under financial stress) may require express provisions to be incorporated into the Trade Documentation at the time of the trade.

Oral agreements under English law are binding as of the trade date. Legal advice should be therefore be sought as early as possible, so that an investor is aware of any potential risks ahead of concluding the trade.

Pre-trade Considerations:

- **Facilities and Nature** – Term Loan, RCF, Letter of Credit, other
- **Regulatory requirements** – A banking licence may be required to conduct credit activities in the jurisdiction of the borrower, which can include the purchase of loans in the secondary market in certain jurisdictions, or any extension of a facility, or change to the interest rate (e.g. Germany).
- **Eligibility requirements** – is the investor able to hold the Traded Portion directly and meet any credit specific obligations under the Credit Documentation.
- **Form of Purchase** – is the Traded Portion capable of being transferred directly, or is a participation or some other form of settlement necessary. Are there specific notice requirements in the relevant jurisdiction (e.g. by hussier in France).
- **Payments on the Settlement Date** – are there any non-standard fees or distributions to which the Buyer considers itself to be entitled. Will the Seller be expected to make a payment to the Buyer on the Settlement Date if the position is unfunded. How will notarial fees be attributed on the Settlement Date.
- **Taxes** – is there any withholding tax on payments of interest, stamp duties or income tax applicable.
- **Matters not covered under the Credit Documentation** – any potentially non-standard arrangements (for example litigation with the Borrower, co-committee arrangements or matters currently subject to negotiation with the Borrower) should be discussed with counsel and confirmed if covered by the LMA Standard Terms and Conditions ahead of any trade.

If there is a requirement to depart from, or add to, any of the LMA Standard Terms and Conditions, the traders should express any non-standard terms as part of the oral agreement at the time of trade.

Parties should ensure that the confirmation is clear and specific regarding the details of the Traded Portion, Form of Purchase and any non-standard terms before execution.

Traders, do not gamble on the LMA standard terms covering all potential pitfalls, or investors may end up with more, or less, than they bargained for.

[Click here](#) for the full judgment.

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