

NOT A SURE THING? LMA SECONDARY TRADES OF SURETY BONDS, BANK GUARANTEES AND LETTERS OF CREDIT

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Legal Briefings - By **Paul Apathy, Tiffany Cheung, Daniel Hyde**

Taken to the English High Court earlier this year, the GSO Credit - A Partners LP v Barclays Bank Plc case centred on the interpretation of key terms used in standard form Loan Market Association (**LMA**) secondary trading documentation. It examined the subject matter of trades concluded under LMA documentation, in the context of a surety bonds facility, and specifically, whether the transfer of a lender's position under a surety bond facility will also transfer the lender's exposure in respect of any issued surety bonds.

The English High Court concluded that:

- where a lender (seller) transfers its position under a surety bonds facility it will generally also have transferred its economic exposure under the issued surety bonds; and
- when calculating the trade settlement amount, the seller's exposure under the surety bonds facility is only 'funded' to the extent that money has been paid by the seller to the beneficiary under issued surety bonds (i.e. the facility is not 'funded' merely because the facility has been drawn through the issuance of surety bonds to a beneficiary).

In making its decision, the High Court considered in particular the key terms 'Purchased Assets', 'funded' and 'unfunded' as used in the LMA's Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims) dated 14 May 2012 (**LMA Terms**).

The case demonstrates that the LMA secondary trading documentation does not provide a comprehensive framework for the treatment of surety bonds, bank guarantees or letter of credit facilities and related instruments (although, in places, the documentation does make references to them). These facilities differ from term or revolving facilities and give rise to additional considerations that the parties should address at the time of entering into a trade.

Whilst LMA secondary trading documentation is governed by English law, the decision is significant given the widespread international reliance upon LMA documentation for loan and debt trades. The decision also has broader application beyond surety bonds to similar instruments and facilities such as bank guarantees and letters of credit.

The decision also highlights a lacuna in the LMA documentation at the time of the trade considered in the case - namely that the LMA Terms provided for the sale of 'Purchased Assets' but not 'Purchased Obligations'. This has been remedied with the introduction of the revised LMA Terms on 3 March 2014.

BACKGROUND

The trades related to a surety bonds facility provided to Codere SA (**Codere**), a Spanish headquartered gaming company, under a senior facilities agreement (**SFA**).

HCC (a major insurance and reinsurance company), was the lender under the surety bonds facility. This saw HCC agree to issue surety bonds in favour of beneficiaries including public authorities in Spain and Italy. Surety bonds were defined in the SFA to include "*a guarantee, indemnity, performance bond, surety bond, documentary credit or other instrument of suretyship*".

Under the terms of the SFA, Codere was obliged to reimburse HCC for the amount of any claim made against HCC by a beneficiary of an issued surety bond.

On 7 June 2013, by back-to-back trades made orally by telephone, GSO agreed to buy from Barclays, and Barclays agreed to buy from HCC, what was to be described as a "*Euro 23,790,371.45 portion of the commitment under the surety bonds facility*" (the **trades**). On that day, HCC had issued surety bonds to beneficiaries with a maximum potential liability (or face amount) of Euro 23,790,371.45.

The trades were confirmed by signed LMA Trade Confirmation (Bank Debt) documents (**Trade Confirmations**) that incorporated the LMA Terms.³

THE ISSUE

Prior to settlement, it became apparent that HCC and GSO had different views as to the effect of the trades:

- On HCC's view, 'Purchased Assets' under the trades comprised only its rights as lender under the SFA. It therefore thought that it had only sold to GSO its right to be paid an equal amount of any claim by a beneficiary under a surety bond by Codere under the SFA, while the contingent payment obligations to the beneficiaries under the issued surety bonds remained for its account.
- In contrast, GSO contended that 'Purchased Assets' under the trades comprised both HCC's rights as lender under the SFA and HCC's obligations to meet any contingent payment obligations under the issued surety bonds.

The interpretation of the effects of the trades impacted the calculation of the settlement amounts payable between GSO and Barclays and Barclays and HCC, pursuant to Condition 13.1 of the LMA Terms. Condition 13.1 calculates the settlement amount as a net sum payable between the parties to a trade on the basis that:

- the buyer pays the seller an amount equal to the 'funded' amount of the relevant 'Purchased Assets' multiplied by the purchase rate agreed between the parties; and
- the seller pays the buyer an amount equal to the 'unfunded' amount of the relevant 'Purchased Assets' multiplied by the inverse of the agreed purchase rate.

On HCC's construction of 'Purchased Assets', HCC further argued that the Purchased Assets were fully 'funded' in an amount of €23,790,371.45 because it had issued surety bonds in that amount. Accordingly, HCC argued that it should receive a settlement amount of €18,080,682.30 from Barclays (based on the agreed purchase rate of 76%) and that GSO should make a corresponding payment of €18,348,323.94 to Barclays on the back-to-back trade (based on the agreed purchase rate of 77.125%). As none of the 'Purchased Assets' were 'unfunded', nothing was payable by HCC to Barclays.

On GSO's construction, because no amounts had actually been paid by HCC under the issued surety bonds, the subject matter of the trades remained wholly 'unfunded' in an amount of €23,790,371.45. Accordingly, GSO should receive €5,442,047.47 from Barclays, who in turn should receive €5,709,689.10 from HCC on the back-to-back trade.

Confusion surrounding the complex deal meant that both HCC and GSO believed they would receive payment at settlement when only one party could be in this position.

Put simply, HCC thought the deal meant GSO would pay it €18m at settlement for GSO to acquire a possible future entitlement. This would be up to €24m, if the surety bonds were called against HCC. The view at GSO was that HCC had agreed to pay it €5m at settlement to take over HCC's possible future liabilities (up to €24m under issued surety bonds, together with the related reimbursement claims).

Caught in the middle, Barclays wanted to ensure the two trades were interpreted consistently.

THE DECISION

The Court found in favour of GSO, ruling that the 'Purchased Assets' included both HCC's rights as lender under the SFA and its contingent liabilities under the surety bonds, and that the Purchased Assets were 'unfunded' for the purposes of calculating the settlement amount.

THE DEFINITION OF 'PURCHASED ASSETS' COVERED BOTH LENDER RIGHTS UNDER THE SFA AND THE LIABILITIES UNDER THE SURETY BONDS

The Court took the view that HCC's interpretation of 'Purchased Assets' was artificial in light of the LMA Terms and related LMA standard forms and documentation.⁴

(a) Can 'Purchased Assets' include obligations as well as rights?

Whilst not specifically addressed in the judgment, the issue appears to have arisen because the LMA Terms at that time only referred to the parties buying and selling 'Purchased Assets'. Similarly, the calculation of the settlement amount only made reference to the value of the 'Purchased Assets' (i.e. no reference was made to 'Purchased Obligations' in these provisions, despite this definition being used elsewhere in the LMA Terms). This meant that for the obligations under the surety bonds to be covered by the trade, they needed to fit within the 'Purchased Assets' definition.

Importantly, 'Purchased Assets' under the LMA Terms was defined as:

"any and all of the Seller's rights, title and interest in and to:

(a) the commitment, advances, other utilisations (including letters of credit), claims and other rights of the Seller... included in the Traded Portion of the Seller's participation under or in respect of the Credit Documentation."

The Court held that, in the context of this definition, the word 'interest' should be '*extended to interest in the form of an obligation, under surety bonds*'. This construction appears to have rested mainly on the following factors:

(i) the Court characterised the transaction as '*a trade of a position under the SFA*' (a description HCC was content with), and found that the more commercial representation of such a trade was a trade that included not only HCC's rights as lender under the SFA but also its liability to pay under issued surety bonds;

(ii) the general framework of the LMA documentation contemplated a transfer of obligations as well as rights (c.f. the definition of 'Purchased Obligations' in the LMA Terms), and the standard form of LMA Transfer and LMA Assignment specifically contemplated the transfer of obligations under surety bonds, bank guarantees and other similar instruments;

(iii) the 2012 LMA Users Guide included a passage that indicated that 'Purchased Assets' were defined to mean the rights included in the traded portion of the relevant asset, '*but subject to the obligations and liabilities of the Seller attributable to the traded portion*'.

(b) Can 'Purchased Assets' include commitments and utilisations under documents other than the relevant facility document?

The definition of 'Purchased Assets' under the LMA Terms referred to commitments and utilisations included in the '*Seller's participation under or in respect of the Credit Documentation*'. 'Credit Documentation' in turn referred to the credit agreement to which the transaction relates as identified in the relevant Trade Confirmation (as well as any related amendments, supplements, accessions, waivers or variations, and all guarantee, security, intercreditor and restructuring documentation).'

The Court considered whether both the SFA and the issued surety bonds fell within the definition of 'Credit Documentation' and appeared to acknowledge there was some potential difficulty fitting the surety bonds within the definition. However, the Court held that even assuming that 'Credit Documentation' only referred to the SFA, the words '*participation under or in respect of*' in the 'Purchased Assets' definition was wide enough to extend to participation (by HCC) as the issuer of surety bonds.

Again, in reaching this view, the Court appeared to be informed, at least in part, by the definitions in the standard form LMA Transfer and LMA Assignment that contemplated transfers of underlying bonds and bank guarantees as well as the facilities under which they were issued.

SURETY BONDS ARE NOT 'FUNDED' IN THE CONTEXT OF THE MEANING OF 'SETTLEMENT AMOUNT' UNTIL SUMS ARE PAID UNDER THE BONDS

The Court also disagreed with HCC's view that the terms 'funded' and 'unfunded' under the LMA Terms should be equated with 'drawn' and 'undrawn' respectively. The term 'funded' is directed to whether money has been actually paid with respect to the facility in question. In the context of surety bonds, it is not the issue of the bonds to the borrower that gives rise to a monetary payment by the lender, or that creates the obligation of the borrower to repay. It is only when the lender pays out on the bonds in response to a request by the beneficiary that a corresponding debt is due by the borrower to the lender.

Accordingly, as no sums had been paid to any public authorities as the beneficiaries under the issued surety bonds, the 'Purchased Assets' under the trades in question were wholly 'unfunded'.

Other points to note

Two other important comments were made by the Court in its judgment:

- the Court rejected attempts by HCC to import definitions from and establish the meanings of terms in the LMA Terms by reference to the underlying SFA. This seemed consistent with applying a 'standard terms' approach to interpreting the LMA Terms; and
- the Court expressed its agreement with Barclays' view that the Trade Confirmations between GSO and Barclays, and Barclays and HCC, should be interpreted consistently with each other.

COMMENT

The *GSO* case highlights the fact that the LMA Terms were not drafted with the transfer of surety bond, bank guarantee or letter of credit facilities as a primary focus. The documentation appears to implicitly assume that the rights and obligations traded arise under the 'Credit Agreement' or 'Credit Documentation' (which definitions do not make explicit mention of separate surety bonds or other instruments issued to third parties).

This issue was compounded by the lacuna in the 2012 LMA Terms which referred to the sale of the 'Purchased Assets' but not 'Purchased Obligations'. This issue has since been remedied.

Undrawn facilities generally create complexities for parties when entering into secondary trades. The LMA Terms calculate a settlement amount that assumes that the undrawn commitment will ultimately need to be funded by the purchaser as the seller must pay the buyer an amount equal to the inverse purchase rate on the unfunded portion. However, this is not necessarily always the case. In some circumstances it may also be appropriate for the parties to factor into the purchase rate the likelihood of the facilities being drawn (as well as any discount based on the recoverability of the drawing once made). These considerations may vary significantly depending on the nature of the instrument issued and the underlying obligations of the borrower.

Whilst the decision in the *GSO* case appears to reflect general market expectations as to the operation of the LMA Terms, some of the reasoning employed to get to that result is somewhat strained.

The case therefore again emphasises the importance of the parties clearly expressing what they are buying and selling when they enter into a trade and complete a trade confirmation. In the case of surety bond, bank guarantee or other similar facilities, it is advisable for the parties to explicitly state (in the trade and the confirmation) whether they are transferring the obligations under the issued instruments (and if so, which ones), as well as the rights and obligations under the facilities.

Consideration should also be given to how the obligations under issued instruments will be transferred to a purchaser. In practice (and despite the references in the standard form LMA secondary trading documentation) novations of such obligations are rare, as beneficiaries will typically require a new instrument to be issued on the same terms from an issuer of the same or better credit quality.

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ENDNOTES

1. This was the first decision made by the English High Court under its new 'Financial List'.
2. [2016] EWHC 146 (Comm).
3. It should be noted that the LMA standard form documents are regularly updated, and the current documents differ in various respects from the documents discussed in this note.
4. Namely the LMA Trade Confirmation (Bank Debt), LMA Transfer Agreement (Bank Debt) (January 2010) (**LMA Transfer**), LMA Assignment (Bank Debt) (24 March 2011) (**LMA Assignment**) and the LMA's Secondary Debt Trading Documentation (Par and Distressed) Users Guide (5 November 2012) (**2012 LMA Users Guide**).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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