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Financial Industry Alert

RESTRUCTURING ADVISORY

Enforceability of Oral Contracts for Loan and Claim Trades

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The Loan Syndications and Trading Association (the "LSTA") scored a major victory in 2002 when New York adopted LSTA-sponsored legislation designed to make oral agreements to trade bank loans and claims arising from business debts legally binding. Since then, participants in both the syndicated loan market and the claims trading market have come to rely upon the idea that trades entered over the phone are binding, so long as the parties agreed to the material terms of the trade.

A 2014 Fifth Circuit Court of Appeals decision calls this assumption into question for loan trading, and a case that is currently pending in New York state court could extend the uncertainty to business debt claim trades as well.

Background: The Statute of Frauds and Loan Trading

One basic tenet of U.S. contract law holds that a party should not be bound to certain types of agreements (such as real estate contracts or contracts that cannot be performed within one year) unless the material terms are put into writing and signed by the party against whom relief is sought. This concept, based on a 17th century English law, is known as the "Statute of Frauds." Since 1994, New York's statutory version of the Statute of Frauds has included an exemption that allows financial institutions to enter into binding oral agreements with respect to certain types of financial contracts, such as currency swaps and futures contracts. At the urging of the LSTA, New York expanded this exemption in 2002 to include contracts for the purchase and sale of bank loans and claims arising from business debts.[1] Shortly thereafter, the LSTA's general counsel commented that the updated exemption brought New York commercial law "into conformity with market practice" and that, as a result of the new legislation, "when agreement is reached on the phone, the law provides clear support for enforcement of the trade, so long as all material terms have been established."[2]

The LSTA Standard Terms

As a result of the New York amendment to its Statute of Frauds in 2002, the LSTA made corresponding amendments to its standard documents. One amendment, which is still in effect today, requires any two parties who execute

[1] N.Y. Gen. Oblig. Law §5-701(b) (McKinney 2014).

[2] Jane Summers, LSTA, Loan Trades Eligible for Exemption from New York Statute of Frauds (2003).

an LSTA trade confirmation with one another to use LSTA documents in future trades and to agree to be bound upon reaching agreement to the terms thereof, "whether by telephone, exchange of electronic messages or otherwise, directly or through their respective agents, and whether the subject of a confirmation." This provision also contains a waiver of defenses based upon the Statute of Frauds.[3] The LSTA explained at the time that as a result of these changes, "a party who fails to sign a trade confirm cannot use that failure to claim that the trade is unenforceable."[4]

The LSTA standard terms[5] anticipate that trade parties will enter into binding oral agreements first and then negotiate transfer documentation based on the appropriate LSTA standard documents.[6] In many cases, this process is a simple matter of filling in trade and administrative details and checking boxes. However, in some cases, negotiating transfer documentation requires a significant amount of negotiation back and forth. The LSTA standard terms contemplate that even parties who fail to agree on transfer documentation are nevertheless bound to settle the underlying trade so long as they agreed to all of the material terms at trade time.

Highland Capital Cases: The 2012 Highland Fifth Circuit Case

According to the record, during a telephone call on December 3, 2009, Highland Capital Management, L.P. ("Highland") agreed to purchase $15.5 million of Regency Hospital, LLC bank loans at a purchase rate of 93.5% of par value from Bank of America, N.A. ("BofA"). During the call, BofA did not notify Highland that trade documentation would require non-LSTA or other non-industry standard terms or conditions.[7] That same day, Highland sent BofA an e-mail confirming that the trade was complete. BofA responded in agreement, but added that the trade was subject to appropriate consents and documentation as well as certain non-standard provisions. Highland had previously traded Regency Loans with BofA using unmodified LSTA standard documents; however, this trade was done with a different group at BofA that required the incorporation of a number of additional confidentiality and indemnity provisions into the trade documentation.

Highland rejected these additional terms and insisted that BofA settle the trade on unmodified LSTA standard documents. Negotiations broke down, the trade never settled, and the Regency Loans were later paid off at par value. Highland sued BofA on the grounds that the parties' telephone discussion created a binding oral agreement subject to the LSTA standard terms, which BofA breached by refusing to settle the trade.

BofA filed a motion pursuant to Fed. R. Civ. P. 12(b)(6) to dismiss the case for failure to state a claim. Under this procedure, the court would decide on the pleadings, without a need for trial, only if there were no material facts in dispute that could affect the ultimate decision. BofA argued that no contract existed because BofAexpressed an intent to be bound to the trade only if the required consents were obtained and documentation acceptable to BofA was signed by the parties. Because these conditions were never satisfied, BofA was never bound to the trade. The United States District Court for the Northern District of Texas agreed with BofA's reasoning and granted its motion to dismiss. The court concluded ,

Highland appealed, and, on October 2, 2012, the Fifth Circuit reversed the district court's dismissal of Highland's breach of contract claim. Highland Capital Mgmt., L.P. v. Bank of Am., 698 F.3d 202 (5th Cir. 2012)("Highland I").

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[3] See Section 22 of the LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations and Section 26 of the LSTA Standard Terms and Conditions for Distressed Trade Confirmations.

[4] Jane Summers, LSTA, Loan Trades Eligible for Exemption from New York Statute of Frauds (2003).

[5] While the LSTA has not published standard documentation for the purchase and sale of claims arising from business debts, many participants in the market use the LSTA standard terms as a starting point for negotiation.

[6] See Section 10 of the LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations and Section 10 of the LSTA Standard Terms and Conditions for Distressed Trade Confirmations.

[7] It is important to note that this fact was changed in Highland II and most likely had an impact on the Court's decision.

The Highland I court applied a four-factor test used by the Second Circuit[8] to determine whether parties intended to be bound to an oral agreement. The test considers: "(1) whether there has been an express reservation of the right not to be bound in the absence of a writing; (2) whether there has been partial performance of the contract; (3) whether all of the terms of the alleged contract have been agreed upon; and (4) whether the agreement at issue is the type of contract that is usually committed to writing." Highland I at 209, citing Powell v. Omnicom, 497 F.3d 124, 129 (2d Cir. 2007).

The Highland I court held that, when viewed in a light most favorable to the Highland[9], there was no indication that BofA expressly reserved the right not to be bound without a writing. Highland alleged that the parties entered into a binding agreement during the December 3, 2009 phone call, and that BofA only attempted to reserve its right to a writing in subsequent e-mails. While there was no partial performance, Highland did allege that the parties had agreed to all material terms of the trade. Finally, the LSTA standard terms indicated that debt trades can be conducted orally, and only later committed to a written confirmation. Highland I at 209.

The court concluded that upon application of this test to the facts, it could not find that the parties did not intend to be bound. The court also noted that the district court's decision to grant BofA's motion to dismisswas premature because a review of extrinsic evidence, which typically involves questions of fact, was needed to determine if the parties intended to be bound.

Highland Capital Cases: The 2014 Highland Fifth Circuit Case

After the Highland I court reversed the district court's order to dismiss for failure to state a claim, the case returned to the district court. The parties conducted discovery, and BofA moved for summary judgment. Relying again on BofA's statements that the trade was subject to appropriate consents and documentation, in August of 2013, the district court granted BofA's motion and found that, as a matter of law, there was no contract to enforce. Highland appealed, and on July 3, 2014, the Fifth Circuit affirmed in an unpublished opinion. Highland Capital Mgmt., L.P. v. Bank of Am., 574 F. App'x. 486 (5th Cir. 2014)("Highland II").

In Highland II, the Fifth Circuit pointed out several facts that were not recounted in Highland I. First, the Highland II court noted that the BofA desk involved did not ordinarily trade bank loans. Second, the court observed that BofA stated the trade was "subject to appropriate consents and documentation" during the December 3, 2009 phone call. In Highland I, the court only discussed the "subject to" language in the context of e-mails BofA sent to Highland ***after*** that phone call.

The Highland II court applied the same four-factor test that the Highland I court used at the motion to dismiss stage, and concluded that there was no genuine dispute as to whether BofA intended to be bound by an oral agreement—to the contrary, BofA clearly expressed an intention not to be bound. The court concluded that: (1) BofA expressly reserved its right to be bound in writing by stating several times during and after the December 3, 2009 phone call that the trade was subject to appropriate documentation; (2) no partial performance occurred, (3) the parties had not agreed to all material terms as Highland had not accepted BofA's additional terms of trade, and (4) regardless of whether this type of agreement was typically committed to writing, BofA expressed a clear intent that this agreement would be put in writing before it became binding.

The court rejected Highland's arguments that the LSTA standard tand the parties' previous dealings would indicate the parties automatically intended to form a binding contract upon oral agreement of the loan, trade amount, and price. The court stated "[t]he LSTA standard terms are not binding law, and so long as [BofA] expressed an intent not to be governed by the LSTA, anything that the LSTA has to say about contract formation is of no import." Highland II at 488.

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[8] See Winston v. Mediafare Entm't Corp., 777 F.2d 78, 80 (2d Cir. 1985).

[9] When reviewing a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), a court must accept "all well-pleaded facts as true and viewing those facts in the light most favorable to the plaintiff" (Highland I at 205).

Solus v. Perry Case: Summary of Facts

A case pending before the Supreme Court of the State of New York, revisits the issues discussed in the Highland cases. The transaction in dispute is a complicated one, involving four parties, two different litigations, and an asset in one of the most notorious Ponzi scheme cases—the bankruptcy case of Bernard Madoff Investment Securities ("Madoff").

Kingate Global Fund Ltd. and Kingate Euro Fund Ltd. (collectively, "Kingate") invested billions of dollars with Madoff. In August 2011, Kingate agreed to sell $1.624 billion of Madoff bankruptcy claims (the "Kingate Claim") to Deutsche Bank ("DB"). DB simultaneously agreed to sell off pieces of the Kingate Claim as participations to various entities. Two entities, Perry Corp. d/b/a Perry Capital ("Perry") and Solus Alternative Asset Management LP ("Solus"), signed trade confirmations with DB agreeing to purchase participations in the Kingate Claim once DB purchased the Kingate Claim. Kingate and DB did not settle their trade and on December 21, 2011; Kingate sued DB for failing to settle the trade (the "Kingate/DB Litigation").

In order to avoid the uncertainty and potential expense of the Kingate/DB Litigation, Perry decided to terminate its obligation to purchase a participation in the Kingate Claim. Because DB was unwilling to allow Perry to terminate the trade, traders from Solus and Perry discussed a trade in which Solus would buy Perry's participation. On April 10, 2012, the parties agreed on price and other material terms. While Perry's trader noted during the call that the trade was "subject to documentation," he sent an email to other employees at Perry after the call stating "we're all out." The parties did not sign a trade confirmation but did negotiate transfer documentation between themselves and with DB. On June 5, 2012, Perry indicated it no longer wanted to sell its participation. On July 3, 2012, Solus sued Perry for specific performance claiming there was a binding oral contract between the parties for the sale of the participation from Perry to Solus, and that Perry had breached the contract by failing to settle. Perry moved for summary judgment, arguing that no binding agreement existed. Solus cross-claimed for summary judgment. Oral arguments on these motions were heard on September 23, 2014. To date, there has been no formal decision by the court, but the hearing transcript indicates the court believes summary judgment would not be appropriate as there are significant issues of fact that need to be resolved.

Based on the hearing transcript, the issues a decider of fact would need to consider are: (i) whether there is an industry custom regarding the binding nature of oral contracts for unsecured claim trades (See, Sept. 23, 2014 Hearing Tr. at 11.24.14, Solus Alternative Asset Mgmt. LP v. Perry Corp., Index No. 652341/12 (N.Y. Sup. Ct.); (ii) whether an agreement that a trade is subject to documentation means there is no binding contract (See id. at 11:17:54-11:18:29); and (iii) whether the need for consent of a third party means there is no binding contract if such consent is not obtained (See id. at 11:45:29-11:35:57).

Because Highland I was decided in the Fifth Circuit and Highland II is an unpublished decision, the Solus v. Perry court is not bound by their rulings; however, we expect they will consider each court's analysis when deciding this case. The four-factor test used in Highland can be applied to the facts presented in this case, and will likely result in different factors favoring each litigant. First, while Perry, like BofA, expressly reserved its right not to be bound, there is an e-mail from Perry indicating they believed they had definitively agreed to sell the claim to Solus and were thus "all out." Second, there was no partial performance here. In fact, the claim was never owned by Perry and was "mired in litigation." Third, Perry is asserting material terms remained open such as the need for DB to consent to the transfer; however, as stated above, e-mails indicate Perry viewed the agreement to sell Solus as complete even going so far as to remove the asset from Perry's books and records. Fourth, as discussed above, it is customary for parties in the claims trading market to bind themselves orally. Because the traders in Solus v. Perry were sophisticated and experienced in the claims trading market, arguments based on industry custom may be more persuasive than in Highland II, where one party did not trade ordinarily trade loans.

Conclusion

Although New York law includes an exemption to the Statute of Frauds for financial contracts like loan and claim trades, courts do not apply it automatically. Rather, courts consider all of the facts and circumstances surrounding the transaction when determining whether the parties intended to enter into a binding oral agreement. Courts will consider the sophistication of the parties involved rather than the sophistication of the organization as a whole. Courts will also examine phone calls, e-mails, and other contemporaneous communications to determine whether a binding agreement materialized.

The cases discussed above also show courts being critical of parties who they view as being too reliant upon industry practice and standard documentation when it comes to contract formation. Courts may also disregard the standard terms of the LSTA confirmation which, as discussed above, provide that parties should be able to rely on prior dealings when determining whether there is a binding trade. Moreover, in spite of the fact that the LSTA standard terms contemplate that the parties will negotiate and sign transfer documentation only after they first enter into a binding oral agreement, some courts will interpret one party's statement that a trade is "subject to documentation" to mean that a binding agreement does not yet exist. .

While parties may argue over many aspects of a trade, whether there was a trade in the first place should never be one of them. It is best practice to execute a trade confirmation as soon as possible after a trade is entered, but this is not always practicable. Accordingly, if an executed trade confirmation is not forthcoming, parties should: (i) confirm that the parties with whom they are dealing are familiar with the LSTA standard terms or other relevant industry customs and intend to work within those guidelines; (ii) be proactive any time a counterparty delivers a communication during or after trade time that could be interpreted as evidence that a binding agreement does not already exist; and (iii) exercise special care when dealing with counterparties and people with whom they do not typically trade. The key to avoiding litigation is to make your intent—and your counterparty's assent—clear and unequivocal.

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