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Character is Doing Right When No One is Looking

Oral Commitments and Moral Casualness in Trading of Trade Claims

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About 15 years ago, when launching a hedge fund with a friend and in that "model portfolio" period before launch, we'd have a lot of time to think and talk. I particularly remember one all hands on office debate regarding *morality* and *character*. It was sparked by an analyst's investment presentation. The analyst punctuated a point about the unlikelihood of a downside case given the legal repercussions for management – they'd go to jail! My co-founder, the thoughtful one of the bunch, asked a question about management's character. He pointed out, that if their choices and behaviors were modified by the threat of jail time – and this is why they behaved, they weren't necessarily moral people. The topic of this daylong debate: Are people moral if they need limits, or the legal threat of punishment, in order to behave? If one "wouldn't do it (whatever *it* is) as they'd go to jail," they may be of morally casual character. Why does one need limits and repercussions to compel honorable behavior?

After a nice run, I've recently wound down my asset management firm, *Tiburon Capital Management*, to do other things: investing for myself and family, perhaps friends, teaching (*Yale, Fordham*), and taking on board and advisory assignments that interest me regarding asset management, liquidation, valuation disputes and failed trade litigation as an expert. The expert witness work I've done related to my recent failed trade claim trade expert assignments and some of my teaching activities have had me recall this debate about morality and character. I think it is relevant as:

1) Bad behavior in the trade claims market persists,

2) Adverse legal decisions regarding failed trades may enhance 'moral casualness' about commitments, and

3) As a distressed cycle nears with a concomitant enlarged trade claims market, all participants would benefit from a more orderly marketplace that comes from the enforceability of commitments and the greater efficiency in pricing as a consequence.

Trade Claims – the Claims of the Trade

While this is really a markets, morality and public policy discussion, some quick nomenclature: Trade Claims are claims for repayment that arise when a vendor, supplier or service provider to a bankrupt company – the "trade" - perform but do not get repaid. Bankruptcy claims trading is the buying and selling of trade claims, claims for repayment against companies seeking protection and relief under the US Bankruptcy Code. A trade claim is a claim against the debtor by a vendor or service provider, for unpaid amounts due them for goods and services.

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The Parties to Trade Claim Trades and Human Biases Part 1

Consider for a moment, if when you read that I am a one-time hedge fund manager, writing about *character* and *morality*, if you didn't cynically chuckle to yourself, thinking of the *irony*. This is, of course, part of the problem. We are human and carry our very human biases and perceptions into our business decisions. Further, when considering the trading of trade claims, with an aggrieved, earnest, hard-working vendor to a bankrupt company, the seller, and the greedy hedge fund, the buyer, don't you perceive unequal knowledge, power and perhaps, tacitly favor unequal standards for each? Just a question you should ask yourself to check your own biases before considering the positions I put forth further on.

Unequal Knowledge Does not mean it isn't Win-Win - The Elegant Symbiosis in the Trade Claim Market (vs other markets)

Unlike markets for equities, bonds and bank loans, markets where large, institutional sized trades are typically transacted amongst financially sophisticated markets participants, the trade claim market can trade institutionally sized obligations, but typically between financial buyers and original trade creditors (vendors or service providers, the 'trade'). In those other mentioned markets, parties to a trade often have similar valuation skills and knowledge, but differing opinion about valuation of the instrument – otherwise, they wouldn't be ordinarily, oppositely, a buyer and a seller at the market price. They are both in the investing and valuation business, so this is *essentially a zero-sum game*. Conversely, the trading of trade claims is win-win as the financial buyer is in the business of wagering on the future perceived value of the claims, whereas the selling trade creditor, in an entirely different business, may simply and logically prefer the cash today from a sale, for use in their core business. Additionally, the buyer is in the business of holding claims for what could be a 2-3 year period or more with no return of cash, and then often in exchange for illiquid securities, such as private equity. The seller selling a trade claim at a discount to the buyer's perceived future value not only gets cash today, but needn't fret the illiquidity and probable valuation outcomes of a future illiquid exchange or distribution.

For these reasons, the relationship between financial buyer and original trade claimant as seller are *symbiotic* – both parties are beneficiaries and value the trade and transaction.

Moral Wiggle Room – Where you Stand Depends on Where you Sit

So *why* would a trade fail? If seller and buyer (often with a broker in the middle) agree on the amount of a trade claim and a price, with the paperwork associated with a trade largely ministerial[1], why would a trade fail? In my experience, it's almost always about a party (usually the trade creditor seller) having

[1] Surely those seeking to break a trade, or counsel representing them, may dispute the contention that paperwork to document the settlement of a trade claim trade (the Purchase and Sale Agreement) is *ministerial*. I've participated in a number of depositions and court testimony where opposing counsel feigned shock at this perspective. But really, what trade breaks, legitimately, over the number of days of notification, the need

second thoughts about price. When this happens, it's usually because the market price bid for trade claims increased *post* the oral or initial commitment to buy and sell, but *prior* to the formal writing between parties, or there is a material positive event in the bankruptcy case, revaluing trade claims higher.

From a behavioral perspective, one might argue that financial buyers are better suited to, have more experience with ever-changing, perhaps precipitous market price change of securities and financial obligations in portfolio, whereas the selling trade creditor have their comparatively more modest personal market experiences, and well, the selling of this one (or historically few) trade claim(s). In behavioral-speak, the financial buyer is "better calibrated" to the experience of price volatility than the seller, and therefore less likely to rationalize the bad behavior, the immorality of seeking to cancel or "walk" on a trade. When reaching for justification, it's easy for the reneging seller to say "we have nothing in writing" or "I didn't realize you meant for us to be bound – we haven't seen, nor will we agree to these egregious terms in the Purchase and Sales Agreement!" Further, the selling trade claimant can rationalize that the shrewd, one dimensionally profit motivated hedge fund buyer had unequal knowledge of the market and valuation prospect. "They tried to take advantage of us." Of course none of this would matter at all if the price went down post initial commitment. In such a case, the financial buyer, in the business of, and calibrated to volatility in market price, would simply proceed to settle and move on.

In short, accepting such a fact pattern, you can see how a calculating seller can use these circumstances to get a 'free' option from the unwitting buyer. If things go right in the bankruptcy case or market, to the benefit of the buyer, the seller can contend there is no writing or they were unclear they were bound. If the facts of the bankruptcy case or market go against the buyer, the seller has a free *put* – closing the trade claim sale at the price and amount agreed to in the initial commitment.

Unequal Standard of Care and Morality – When and Why Trades Fail

First off, not to overstate this - trades rarely fail. For the reasons mentioned about, all three of the trade claimant seller, the financial buyer and broker/dealer intermediary (to the extent there is one involved in the trade) have a vested interest in seeing the trade close promptly. Time is of the essence in closing and (time) is not one's friend, or better put, can erode the sense of community of interest and allow for creeping remorse and second guessing the buy/sell decision.

For example, if an oral commitment is made, *"I can offer $1 million of Amalgamated Widget Trade Claims at 75 cents on the dollar". "You're done, I buy $1 million of Amalgamated Widget Trade Claims at 75 cents on the dollar",* and news comes out in the Amalgamated Widget bankruptcy, i.e., a company commits to buys Amalgamated Widget and pay trade creditors 100 cents on the dollar, and the trade claims bid moves up to 90, or conversely, the company that was in contract to buy Amalgamated Widget at 100 just walked,

to represent you own and have authority to transact, or that you will repay money or distributions you receive in error? These are purely administrative details.

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cratering the market bid of trade claims to 40, you can imagine the misgivings of either party. This is why, trade claims, *as in all other markets for financial instruments*, risk of ownership transference upon initial commitment, on "trade date", is essential to reduce the plausibly heightened temptation to bad faith. The morally casual, finding it expedient, and some courts, through narrowed consideration or indifference or bias favoring a purported less sophisticated selling trade creditor, may differ – to the detriment of all market participants.

Your Word is Your Bond – Part 1

Financial buyers, in the business of being in markets daily, trading equities, bonds, bank loans and trade claims – *financial instruments* - understand and accept the gravity of commitment, the meaning of the uttered (or written words) "I buy" or "I sell". Those of you that had parents that discussed character and keeping promises, when you were a kid, got this early on. Those of you that ever passed through Wall Street training programs or sat any appreciable time on a trading desk, likely heard the explicit saying – "your word is your bond". Those of you that ever engaged a customer for your business understand the import and presumed reliance on your words – based upon the shared value and community of interest in mutually desired commerce. We are taught as children, as layman and as investment professionals, that our words have meaning and that people of good character, live up to promises and commitments made. Part and parcel of this moral and reasonable life/work standard is that we also operate in *good faith* with one another. Does it not flow naturally from an obligation to stand up on our commitments, that we operate in good faith to see them through to the mutually anticipated conclusion? Therefore, if one says, "I sell", that one would then operate in good faith to undertake to fulfill on that commitment? The converse is that our words are a ruse: we know they are eliciting a reaction from those that hear them, and that an expectation arises, and we count on our words to deceive, hopefully, without repercussion. This is bad faith.

Your Word is Your Bond - Application to Securities and Between Investment Pros and Laymen

Other markets for financial instruments have time-tested tradition around the enforceability of oral commitments. The reason being that market trading prices of securities or financial obligations can swing rather dramatically with events, news and market gyrations. For this reason, for the preservation of liquidity in markets valued as an inherent public good, securities and other financial obligations sales are effected by the initial or oral commitment.

Oral buy-and-sell orders and commitments have a long history as the practice in the securities industry, not only amongst market professionals, but also between market professionals and layman, or individuals with investments in public securities. FINRA, the congressionally authorized governing body dedicated to protecting America's individual investors through regulation of broker-dealers to insure fair and honest

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operations, has stated in its Registered Representatives Brochure[2] "(O)rders for securities transactions are contracts. Unlike many business contracts, which are usually written, most securities orders are verbal."[3] FINRA's standard applies to transactions in equities and bonds amongst financial institutions as well as between institutions and individuals.

Equities and bonds are securities, but loans and trade claims are not. Despite this difference, however, in the context of a commitment to effect a trade, *it matters more that equities, bonds, bank loans and trade claims are all financial instruments, and further, that both buyers and sellers are seeking the same outcome in engaging one another*, *an agreement on price and amount and transference of risk.*

Your Word is Your Bond - First Equities and Bonds, then Bank Loans (Non-Securities)

In the late 1980's, corporate bank loans began to trade. I was an early and active participant in the evolution of this trading market as well. Loans then, were largely traded amongst US banks and US bank branches of foreign banks. The first non-bank performing loan ("Prime Plus") mutual funds entered the market at this time. Between the relative homogeneity of buyers and sellers and low price volatility given robust markets and access to capital, there were very few failed trades circa 1988-90.

The vilification of *Drexel Burnham Lambert* and *Junk Bonds* led in part, to a large number of bankruptcies in the 1990-92 era as poorly financed companies lacked access to capital markets. The fledgling loan trading markets experienced large price volatility. This drew the attention of hedge funds and other institutional investors that invested in distressed situations. With loan trading already happening in a nascent form, there were personnel and skills in the loan market sufficient to drive a coming burgeoning distressed loan trading industry. Similar to the issues discussed herein regarding the trade claims market, the early distressed commercial loan trading market (1990-94) experienced the same occasional bad actor (banks, brokers and hedge funds) that would attempt to renege on an initial commitment due to remorse over a buy/sell decision, often stoked by a favorable or unfavorable bankruptcy case development. In striking similarity to the failed trades in the trade claims market, parties to distressed loan trades in this time, often original selling banks and buying hedge funds, would fall back on arguments of differing sophistication and knowledge, and of a failure to distill an oral or initial commitment to a writing (with loans, an Assignment or Participation Agreement) executed by both parties. Practitioners in the loan market found it expedient, good commerce and policy to make oral commitments actionable. As an interest group, the *Loan Syndications and Trading Association* (the "LSTA") was formed in 1995 to promote a fair, orderly, efficient, and growing corporate loan market and provides leadership in advancing and balancing the interests of all market participants. The LSTA drives much of the corporate loan market's standardized documentation and industry perspective.

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[2] FINRA Registered Representatives Brochure

[3] IBID

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Trade Claims are *Unintended* Financial Instruments, but Financial Instruments Nonetheless

Financial instruments are a differing class of asset versus, say, a car or a house and should "trade" with conventions substantially similar to like-kind assets. Unlike the buying and selling of consumer assets like a car or home, objective indications of the moment of agreement are critical because the value of equities, bonds, bank debt and trade claims can change precipitously from day to day, even moment to moment. For this reason, to facilitate the benefits of an orderly marketplace, all financial instruments should trade upon oral or initial commitment. Regarding trade claims (and to a degree, bank loans), once an agreement is reached, it is important that the parties work *honestly* to "settle the trade" by completing due diligence, if any, and documentation, thereby ensuring that one side does not get a free option to rescind the agreement if circumstances or the markets change.

Your Word is Your Bond – Trade Claims Trading Process

Trade claims are obligations of a company (a bankrupt one) with value rooted in the present value of the future perceived value of a general unsecured claim against that company. Put more simply, the trade claim can and should often be worth what other like stature obligations or securities are trading for in more traditional securities markets, adjusted simply for liquidity differences and costs of trading. Simpler yet, general unsecured bonds, which may have liquid traded markets and general unsecured trade claims routinely are worth exactly the same value upon a company's reorganization. Why should there be differing standards for how bonds and trade claims - these like assets - trade?

As every claim arises from an unpaid obligation of the debtor, unlike securities, trade claims are not *contemplated* obligations, evidenced by a security certificate, loan agreement or bond indenture; rather, they are created by a failure to pay by the bankrupt company. Therefore, each trade claim, if sold, involves some due diligence by the buyer before executing a Purchase and Sale Agreement and releasing wired funds. This one distinction necessitates some time for due diligence between trade date (initial commitment and transfer of risk) and settlement date (execution of a Purchase and Sale Agreement and wire of funds). The trade claim trading industry operates with an implied good faith standard regarding these procedures, that parties will forthrightly complete due diligence, negotiate and execute a Purchase and Sale Agreement, and wire funds expeditiously. The time it takes to get from trade date to settlement date may be as short as with equities and bonds (3 business days typically), but is more akin to bank loans (routinely plus or minus 10 days).

The rapidly changing value of equities, bonds, bank loans, and yes, trade claims, necessitates that parties confirm trades as soon as they reach agreement on amount and price. Confirmation for all these financial instruments can occur in different ways, including telephonically, by email, text message, in a writing or any combination thereof. With trade claims, confirmation is sometimes followed up in a subsequent writing once the buyer and seller agree to the purchase and sale of a trade claim for a price and amount.

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This confirmation, whether oral or written, usually states that the transaction is only subject to satisfactory standard and typical due diligence by the buyer. While there are these additional conditions to *closing* (settlement for cash), the trade is known by both parties and is in effect, with risk of ownership transferred to the buyer upon an oral or initial confirmation.

While this is trade claims market industry convention, and black and white, clever but remorseful parties seeking subsequently to renege on commitments to buy or sell, will argue the gray – "there is no trade, we didn't know we'd committed to sell, we never signed anything"...

Navigating the Gray - Some Final Musings on the "Disparities" Among Financial Buyers and Original Trade Creditor Sellers

What should a markets participant think about a seller of trade claims when engaged in a dialog about their selling a trade claim? Can one presume that the selling company/institution has the authority to commit to such a transaction? Does the selling trade creditor opt into ratable contracting party status in the choice to engage a buyer regarding this form of financial instrument? I think so. Further, there's likely been frequent calls and correspondence to the prospective selling trade creditor from interested financial buyers and intermediaries regarding the trade claim, market price and trading mechanics in the interim. In larger bankruptcies, trade creditors with the largest trade claims will have regular communications regarding their trade claim, whether an interested seller or not. Given the community of interest shared with the selling trade creditor, of a smooth transaction with no surprises, the selling trade creditor's persistent and broad dialog with market participants "socializes" the selling trade creditor to the trade claim market's dynamics – *including that risk transfers on initial commitment*.

Most seasoned managers and decision-makers of companies holding trade claims as the original vendor/service-provider, have likely had experience executing securities trades in their personal accounts. Their engagement with their broker/dealer and the actionability of oral commitments to buy or sell securities would inform a perspective about what a financial buyer of a trade claim expects after the "I buy/I sell" exchange between parties.

If You Don't Know Who the Sucker at the Table is…Human Biases Part 2

The individuals that communicate with the prospective selling trade creditor, often called "sourcers" as they *source* the trade claim, have compensation quantitatively defined, or closely approximating a quantitative calculation. The sourcer, the buyside fund (manager) and prospective selling trade creditor all share a community of interest in a swift, surprise-free closing. The seller and intermediary also both share an economic interest in a high price (the seller receives an enhanced recovery, the intermediary may receive an increased commission depending on how its calculated, or at minimum, a greater likelihood of a contented, and therefore, perhaps, a repeat seller). Only the buyer typically has an interest in a low price. Routinely, sourcers are younger, less experienced people, doing the entry-level work on a

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desk. Often, the selling trade creditor counter-parts, at minimum, the decision-makers, are more seasoned, senior, often materially older and experienced people. Who's the sharpie in this exchange?

Let's Do this Right

We're nearing an eventual distressed cycle, where debt-laden companies in an increasing interest rate environment, perhaps a recession, face coming heightened financial risk to business. The inevitable cycle will likely produce a great scale of bankruptcies. The number of investment firms specializing in distressed investing and the magnitude of capital they manage for such purpose will drive significant trading and with likely better liquidity for prospective sellers than past cycles. The distressed investor's wheelhouse includes the bankrupt company's full capitalization: equities, bonds, bank loans and trade claims. There can/will be enormous price volatility, day to day, even moment to moment, among these *financial instruments*. Oral buy-and-sell orders and commitments have a long history as the practice in the securities industry, and by application, to the corporate loan market. It is the practice amongst parties to the trade claims market, but should be enforceable, as with all other like financial instruments.

While trade claims, and bank loans, for that matter, are not securities, it's of more importance that equities, bonds, bank loans and trade claims *are all financial instruments*, and further, that both buyers and sellers are seeking the same outcome in engaging one another at all, an agreement on price and amount and transference of risk.

We are taught as children, as layman, that our words have meaning and that people of good character, live up to promises and commitments made. Part and parcel of this moral and reasonable life/work standard is that we also operate in good faith with one another. Does it not flow naturally from an obligation to stand up on our commitments, that we operate in good faith to see them through to the mutually anticipated conclusion? Therefore, if one says "I sell" or "I buy," that one would then operate in good faith to undertake to fulfill on that commitment? The converse is that our words are a ruse: we know they are eliciting a reaction from those that hear them, and that an expectation arises, and we count on them to deceive, hopefully, without repercussion. This is bad faith. Let's hold counter-parties, buyer and seller in a trade claim trade, to this simple and understood obligation to stand up to commitments made.

Peter Lupoff teaches at Fordham Gabelli School of Business, advises Yale University student funds and is a long-time participant in distressed markets. He presently invests via his family office.