CADWALADER

FUND FINANCE FRIDAY

Oh, Those Disqualified Lender Lists...

April 7, 2023

By Linda Filardi
Counsel | Fund Finance

Bloomberg recently reported that some lenders were setting up trading desks focused on private debt. This, together with the recent events in the banking market and regulatory capital-driven exposure reductions that have been underway for some time now, has caused many lenders to examine the restrictions on loan sales imposed by borrowers via assignment consent rights and the disqualified lender list (the "DQ List") – the list of entities that are disqualified from becoming lenders or participants under the credit agreement.

This once-off list that was limited to a handful of commonly-known "loan to own" funds – those funds purchasing distressed debt with the intention of taking action against the borrower and gaining a controlling stake in the company – has grown to be a list containing, in many cases, every single competitor in a given sponsor's market. Long before the Great Financial Crisis, these lists picked up momentum as borrowers became more and more concerned about who owned their debt. Capital markets desks, now eager to trade potentially troubled loans, may be surprised to discover how extensive the DQ Lists have become and how permanent the restriction on trading. While DQ lists are not common on many subscription loans, similar concepts do exist in many large sponsor deals via competitor anti-assignment clauses and related consent rights.

Just last year, the LSTA published a market advisory outlining some of the more recent changes to the disqualified institution provisions set forth in the LSTA's Model Credit Agreement Provisions (the "MCAPs"). It contained certain updates to the 2014 LSTA DQ Structure that was originally formulated to balance competing interests of borrowers, sponsors and lenders. For years, market participants grappled with the many issues surrounding the DQ Lists: At what point in the transaction were they required to be delivered? Could the borrower add to the DQ List? Did it go away upon a default? What happened if the loan sale was to an affiliate of an entity on the DQ List? Could the list be publicly disclosed? To whom and how? And the list (*no pun intended*) went on ... Who would be responsible for enforcement? What happens if the loans ended up with an entity on the DQ List who in turn trades the loan to another party? What are the mechanics of an unwind?

Here is a brief review of the LSTA DQ structure with some commentary about where the market generally landed. Perhaps now is the time to revisit some of the negotiated points to allow the debt to more freely trade. Lengthy DQ Lists negotiated during a period of low interest rates and abundant credit may now cause heartburn when banks want to quickly liquidate and trade their positions.

Creation of the DQ List: Entities included on the DQ List include (i) any entities the borrower identified to the agent at or prior to the *closing of the commitment letter*, (ii) any other entities that the borrower identified to the agent from time to time that are competitors of the borrower or its subsidiaries, and (iii) any affiliates of those entities that are identified to the agent. Emphasis should be on early delivery of the DQ List because far too often the DQ List is the last thing to be delivered prior to close, leaving very little time for the agent to review the list and determine whether it is reasonable. Does this list contain all or most all of the likely purchasers of the debt once it is distressed? Likely it does. Has the trading desk been consulted and reviewed the list? Is there sufficient liquidity in this loan to warrant the size of the list that has been delivered? Don't overlook the affiliate point: some of the largest credit funds and potential buyers may be affiliates of sponsors on the DQ List.

Additions to the DQ List: Under the LSTA DQ Structure, borrowers are permitted to add competitors to the list with sufficient notice, understanding that the borrower is required to deliver confidential information, such as financial statements and management reports, under the credit agreement, and permitting competitors to see that information is of utmost concern. Borrowers are not, however, typically allowed to add financial institutions as that should be determined at the outset and they represent the most likely purchasers of debt.

Expiration of the DQ List: Here is where the rubber hits the road. Lenders argue that once there is a default, all bets are off: the list falls away and the lenders should be able to freely trade the loan because the borrower has stopped performing – the benefit of the bargain has expired. Borrowers, on the other hand, often have the opposite view: a default situation is exactly the time when lenders should be restricted from selling the loans to purchasers and competitors whose interests diverge from the borrower/sponsor. The LSTA DQ Structure permits the DQ List to stay in place and large cap sponsors are largely successful in the broadly syndicated loan market on this point; however, the same is not true in many fund finance or middle market transactions. While in the broadly syndicated loan market, this approach might make sense given the wide variety of participants, in the middle market, and in certain parts of the fund finance market, these loans do not enjoy the same kind of liquidity and, as a result, the pool of potential purchasers is far fewer. In a newly-minted private debt trading platform, participants may want to reexamine their positions on this issue.

Disclosure of the DQ List: Lenders were always hesitant to disclose the existence of DQ Lists because, among other things, the entities on the DQ Lists were also their clients. Sponsors similarly wanted confidentiality around who they were restricting. Nondisclosure presents challenges in the broadly syndicated market, however. Purchasers of loans need to know at the outset the extent to which there are limitations on the sale of these loans. The MCAPs settled this by making it easier for lenders to see the DQ List by authorizing the administrative agent to post the DQ List on Intralinks or a similar debt platform on the public side.

Liability for Violations of the DQ List: Taking a cue from the LSTA DQ Structure, most documents make clear that the administrative agent has no liability for monitoring the DQ List; the DQ List has no retroactive application, and transferring a loan to a Disqualified Lender does not void the trade but rather allows the borrower to, among other things, “limit the Disqualified Institution’s access to confidential information, engaging in fundamental lender actions or taking part in creditor decisions.” As a remedy, Borrower may also buy back the loans, thereby settling the operational nightmare of unwinding a trade.

Is it time to revisit these extensive DQ Lists and the various credit agreement permutations and ask whether the negotiated provisions are the right construct for each segment of the market? Might lenders want more flexibility as they examine the vast portfolios of loans they have amassed over the last decade of low interest rates? Might they be better off with limited lists that fall away upon a default, and certainly, upon a payment default? Should some of these restrictions be applicable in a nearly $3TN broadly syndicated market? Similarly, should the same constructs be applied in the much less liquid middle market fund finance market? There is no time like the present...