

CLIENT ALERT

The Loan Settlement Waterfall And Why "Legal Transfer/Assignment Only" Can Be Misleading

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Settlement certainty is a required feature of any global credit market. The secondary loan market aspires to that goal; however, ensuring absolute certainty of settlement has proven elusive due to several reasons, including the complexity of the underlying loan product. There are no robust electronic settlement platforms, transfer documentation is negotiated between counterparties, definitions of “eligible assignee” vary by credit agreement, and borrower-generated confidential lists of disqualified lenders, pre-qualified “white-listed” lenders and ineligible competitors further confuse the overlapping sets of entities that can or cannot become members of the lending syndicate. Numerous consents to transfer a loan may be required, including consents from the borrower, the administrative agent, the letter of credit issuer and other interested parties. And even if these hurdles are overcome, transfers of loans may be arbitrarily “frozen” by a borrower or administrative agent during a lengthy reorganization or restructuring.

In addition, during periods of market volatility, secondary loan trading can be subject to a wide variety of factors which further impact the settlement of a trade. Parties may be affected by price fluctuations, market liquidity issues, declines in financial performance of a borrower and increases in borrower default rates. These factors can have a significant influence on the willingness of parties to close a trade quickly and efficiently and, in extreme cases, a party may attempt to walk away from a transaction if substantial movements in price occur and the trade cannot settle in the manner originally intended.

In both Europe and the U.S., the secondary loan market has developed contractual frameworks designed to inspire confidence among market participants that their trades will indeed settle. The standard terms and conditions for secondary market loan trades published by the Loan Market Association (“LMA”) in Europe and the Loan Syndications and Trading Association (“LSTA”) in the U.S., respectively, are constructed to provide certainty and protection to parties seeking to complete the settlement of a trade. The principle of a “trade is a trade” is reinforced by the inclusion of mandatory settlement obligations within both the LMA and LSTA standard trade confirmation terms and conditions, which solidify the understanding that the parties are obligated to settle the transaction from the trade date.

A “trade is a trade”

The “trade is trade” principle means that, once a trade is agreed (either as an oral or written agreement), even if certain conditions to the transfer remain unfulfilled (e.g., such as failure to obtain borrower consent), the parties may not simply cancel the trade. Instead, the trade remains open (and the contract to buy and sell the loan remains binding) until a suitable settlement method is achieved by the parties.

This overarching principle of “a trade is a trade” is set out in Condition 6 (*Mandatory Settlement Obligations*) of the LMA standard terms, and Section 1 (*Target Settlement/Settlement Date/Transfer of Debt*) of the LSTA standard terms, and both frameworks outline a “settlement waterfall” the parties are obliged to follow where certain conditions or consents for settlement have not yet been fulfilled by the proposed settlement date.

Mandatory Settlement Obligations and the Settlement Waterfall

At the time of agreeing the trade, the parties will usually decide the form of purchase to be used to deliver the traded asset to the buyer. This would typically be by legal transfer (i.e., novation or assignment) under the LMA, or assignment under the LSTA, in each case using the form of transfer document prescribed in the underlying credit agreement or, in some cases, by participation using either the LMA or LSTA standardised form. If at any stage after the trade date it is no longer possible to settle by the agreed form of transfer mechanism, the mandatory settlement provisions in both the LMA and LSTA standard terms and conditions set out the next form of settlement that the parties are obliged to follow.

This automatic fall-back to the prescribed settlement methodology is determined by which form of purchase the parties originally agreed to, and the waterfall works in the following way:

- **“Legal Transfer” (LMA) or “Assignment” (LSTA):** if the parties have elected that the form of purchase will be “Legal Transfer” or “Assignment” (as applicable) by transfer certificate/assignment agreement and a required consent or other transaction specific condition is not satisfied, the trade must be settled by participation. If settlement by participation is not possible or the parties fail to agree a form of participation agreement to be used, then the trade must instead settle on the basis of an alternative structure or arrangement mutually acceptable to the parties and which provides the parties with the economic equivalent of the agreed-upon trade (the “Alternative Settlement Method”). This can include a cash settlement or derivative structure.
- **“Legal Transfer Only” (LMA) or “Assignment Only” (LSTA):** if “Legal Transfer Only” or “Assignment Only” (as applicable) has been selected by the parties, it is agreed that the trade will settle by way of legal transfer or assignment; however, if any required consent or other transaction specific condition is not satisfied, rather than settlement by participation, the parties are obliged to settle the trade using an Alternative Settlement Method.

It is worth noting that the “Legal Transfer Only” (LMA) and “Assignment Only” (LSTA) concepts might be misleading to those market participants who are not aware of how the “trade is a trade” principle pre-empts and overrules the ‘form of purchase’ election in the trade confirmation. Despite what the terms suggest, parties are not entitled to simply walk away from the trade if it is not possible to settle the transaction by legal transfer or assignment. Parties selecting “Legal Transfer Only” or “Assignment Only” (as applicable) will still be bound to settle the trade even if the required conditions to settlement in this manner are not met; except that settlement will instead move straight towards the Alternative Settlement Method, rather than falling back to participation.

- **“Funded Participation” (LMA) or “Participation” (LSTA):** if the parties have elected to settle by way of a funded participation under the LMA framework or participation under the LSTA framework (whether by choice or as a result of regulatory or banking licence considerations, failure to receive a required consent, or other limitation which prevents the buyer from holding the asset in its own name), and any other transaction-specific condition remains unfulfilled at settlement, the trade must settle using an Alternative Settlement Method.

To further the goal of settlement certainty that is necessary in the global secondary loan market, the contractual framework of both LMA and LSTA trading documentation operates on the understanding that no trade is conditional, and unless otherwise agreed, the mandatory settlement obligations under each of these trading regimes will always require the parties to find a way to settle the transaction.

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