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Personae Non Gratae in the Loan Market: Trading Considerations for Disqualified Institutions

By Robert J. Waldner and Paul B. Haskel*

In this article, the authors explain that although being listed as a "Disqualified Institution" presents significant barriers for a party seeking to invest in the secondary market for syndicated bank loans, there are some alternative approaches that investors may want to consider to otherwise gain exposure to a borrower's credit.

From the inception of the secondary market for syndicated bank loans some 35 years ago, there has been continuous movement in the direction of increased liquidity for the asset, but recent developments in this market point toward a reversal of this trend.

Over this period, once-common devices designed to limit the transferability of loans and ensure that only commercial banks could hold them, such as restrictive definitions of "Eligible Assignees" and onerous minimum transfer requirements, have fallen out of favor. Consent requirements have been softened by carve-outs, reasonability constraints and provisions which deem consent to have been granted unless it is affirmatively denied within a fixed period.

Trading documents have become standardized, electronic settlement platforms have been developed, and average trade settlement times have shortened. As a result, according to The Loan Syndications and Trading Association (the LSTA), secondary loan trading volume reached $821.4 billion in 2024, representing a 15% increase over 2023, and second only to 2022's total.

However, the recent proliferation of "blacklists" (known as Disqualified Institutions lists) in credit agreements has resulted in an environment in which investment managers who could be seen as competitors of a sponsor, or who might otherwise be perceived as aggressive or difficult counterparties, have been excluded from the market for certain loans, thereby decreasing overall market liquidity.

While being listed as a Disqualified Institution presents significant barriers for the relevant investor, there are some alternative approaches that investors may want to consider to otherwise gain exposure to credit of the relevant borrower.

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HOW DOES AN ENTITY BECOME A DISQUALIFIED INSTITUTION?

Generally, a prospective lender becomes a Disqualified Institution upon being designated as such by the borrower. A borrower's ability to add names to the Disqualified Institution list (the DQ List) after the initial closing of the loan is generally the subject of upfront negotiation between the borrower and the lenders, but typically this discretion will not be unfettered. The LSTA's 2023 Model Credit Agreement Provisions (the LSTA Model Provisions) suggest that Disqualified Institutions be limited to:

(i) Persons designated as such by the borrower by written notice delivered to the arranger on or prior to the date of the commitment letter;

(ii) Persons that are "competitors" of the borrower or any of its subsidiaries who are designated as Disqualified Institutions by the borrower by written notice delivered to the administrative agent from time to time; and

(iii) Affiliates of any of the entities described in the preceding clauses (i) or (ii) which either (x) have been designated by the borrower by written notice delivered to the administrative agent from time to time, or (y) are otherwise reasonably identifiable as affiliates solely on the basis of the similarity of their names to the names of any entities on the list of Disqualified Institutions (the DQ List).

Under the LSTA's approach, only "competitors" and affiliates of existing Disqualified Institutions should be added to the DQ List after the date of the commitment letter, but there are many real-world examples of credit agreements in which the borrower is free at any time to designate a non-competitor as a Disqualified Institution.

WHAT ARE THE CONSEQUENCES OF BEING LISTED AS A DISQUALIFIED INSTITUTION?

Consequences vary from agreement to agreement, but there are several challenges that a Disqualified Institution can expect to face. At a minimum, lenders will be prohibited from assigning their loans and commitments to Disqualified Institutions, with any such assignment constituting a breach. In the overwhelming majority of cases, this prohibition will also extend to lenders granting participations to Disqualified Institutions. The LSTA Model Provisions do provide an exemption for trades that were entered into prior to the date on which a buyer was added to the DQ List (regardless of whether those trades have settled), but other formulations limit this carve-out to settled assignments or participations.

Some credit agreements go even further and prohibit lenders from entering into total return swaps, credit default swaps or other derivative instruments with a Disqualified Institution under which any obligation of the borrower is the sole reference obligation. This prohibition does not, however, appear in the LSTA Model Provisions.

In many cases, a loan agreement will include a provision indicating that any assignments or participations to Disqualified Institutions will be deemed null and void, ab initio. Alternatively, credit agreements that do not include such provisions will often give the borrower the right to compel a Disqualified Institution to dispose of its loans, typically in exchange for the lesser of (x) the outstanding principal amount and (y) the amount that such Disqualified Institution paid to acquire them.

The LSTA Model Provisions do not deem such transfers to be null and void. Instead, they provide that Disqualified Institutions that hold loans will not have rights to:

(i) Receive confidential information to which other lenders are entitled;

(ii) Attend lenders' meetings;

(iii) Vote on proposed amendments or waivers to the Credit Agreement; or

(iv) Vote on the borrower's plan of reorganization in a bankruptcy proceeding.

CAN LENDERS ACCESS THE LIST OF DISQUALIFIED LENDERS?

The LSTA Model Provisions suggest that the administrative agent should have the right to (i) post the DQ List on the electronic platform used to deliver information to the lenders (e.g., Debt Domain, Intralinks, Syndtrak, DebtX, etc.), and/or (ii) provide the DQ List to each lender who requests it. However, we have seen many examples of credit agreements that prohibit the posting or sharing of the DQ List, only permitting the administrative agent to confirm, in response to an inquiry from a lender, whether a specified potential assignee or participant is a Disqualified Institution. Since most credit agreements require an assignee of loans to represent that it is not a Disqualified Institution, this can create an awkward situation where the accuracy of a buyer's representation is entirely dependent on the accuracy of the administrative agent's response to its seller's query.

WHAT ARE SOME TRADING OPTIONS A DISQUALIFIED INSTITUTION MIGHT CONSIDER?

While these restrictions present significant issues from a trading and investment perspective, there are alternative structures that Disqualified Institutions may want to consider in order to gain exposure to a borrower's credit. They each come with drawbacks, and their suitability for any particular situation will depend on the investor's goals. Their availability will also depend on the precise terms of the credit agreement.

To the extent that an investor's priority is the receipt of principal, interest and fees payable in respect of the loans, a total return swap or similar derivative arrangement where a counterparty agrees to deliver a stream of future payments that mirror a lender's cash flows in respect of the loans could be a viable alternative. Since this does not involve a transfer of ownership of the loan, it typically will not run afoul of the restrictions applicable to Disqualified Institutions, although, as noted above, some credit agreements do prohibit lenders from entering into these types of contracts.

Counterparty credit risk is a concern here, as the absence of any ownership interest in the loan means that a buyer will have nothing more than a contractual claim against its counterparty in the event of seller's insolvency. Also, derivatives typically do not provide buyers with voting rights with respect to the loans (they generally will not even require that sellers own the loans at all), so investors looking to have a say in amendments or restructurings may be frustrated.

Theoretically, a buyer could explore bespoke arrangements that provide it some rights to direct sellers' actions (e.g., a requirement that in the event that a seller happens to hold the loans, it will follow buyer's voting instructions), but there is some uncertainty as to whether this sort of workaround could be viewed as a breach of a credit agreement's restrictions on transacting with a Disqualified Institution, and the seller of such derivative might well be hesitant to risk their agreement being recharacterized as a prohibited participation. Even a willing seller would still face restrictions on passing along non-public information to a Disqualified Institution that would make soliciting instructions impractical in any case.

Many Disqualified Institutions have considered other approaches, such as holding loans via subparticipations or setting up special purpose vehicles that are designed to fall outside of the boundaries of a credit agreement's definition of a Disqualified Institution. All of these settlement structures are more complex than assignments or participations and will generate higher transaction costs than typical loan trades. Tactics of this nature may be described as being less than transparent regarding the Disqualified Institution's involvement, and could create the risk of a dispute with the borrower or the sponsor if they were to come to light. Disqualified Institutions should carefully evaluate the credit agreement's restrictions and assess the risk of a borrower asserting that these have been breached before entering into any such transaction.

CONCLUSION

Before entering into a new bank loan trade, it is advisable to thoroughly review the provisions in the credit agreement governing Disqualified Institutions, and to determine whether the prospective buyer is on the DQ List. This holds for sellers as well as buyers, since discovering that it has entered into a trade with a Disqualified Institution will not relieve a seller of its obligation to settle, which becomes much less straightforward once assignments and participations are taken off of the table.

Buyers that are not Disqualified Institutions should assess the risk of being designated as such in the future and consider the potential impact of such a designation on their investment strategy.

Prospective buyers that find themselves on a DQ List should carefully consider their investment objectives in connection with formulating alternative settlement structures. Working through these issues prior to entering into a trade will enhance the buyer's ability to implement its preferred approach.