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Distressed Debt & Claims Trading ADVISORY ■

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Disqualified Lender Provisions: Broader Borrower/Sponsor Powers Pose Problems for Secondary Loan Market Participants

Lenders, market-making trading desks, and buyside investors must be leery of the ever-expanding powers afforded borrowers and sponsors under disqualified lender provisions in syndicated credit facilities. Most credit agreements in the $1.5 trillion broadly syndicated loan (BSL) market prohibit lenders from being able to assign or participate loans to a party on a disqualified lender list. Typically, a DQ list (often referred to as a "blacklist") includes competitors of the borrower and specific entities identified by the borrower/sponsor at the closing of the credit facility.

Historically, the breadth of DQ provisions in credit agreements tracks the market guidance provided by the Loan Syndications & Trading Association (LSTA). The most recent LSTA market advisory from June 2022 noted that the DQ structure is intended to provide a balance between allowing borrowers to exclude competitors (and other entities for legitimate business reasons) from becoming lenders in their capital structure while not unduly impeding liquidity in the secondary market. For this to occur access to the DQ list needs to be readily available. Unfortunately, in practice, the DQ list is not regularly posted, and access to the list is often difficult to obtain.

Most credit agreements allow a lender to request a copy of the DQ list from the administrative agent. Often, multiple requests are needed to facilitate an agent response for the DQ list, and then days will pass before receiving it. Then, instead of providing the full list, the agent will often ask the requesting lender who the prospective assignee is, further slowing down the process. For loan traders, speed of information is paramount because there may be competition for bids on loans. Parties that wait to find out whether an end buyer is on the DQ list may lose out on a trading opportunity while other more cavalier trading desks move forward.

Secondary trades are generally entered into before performing diligence on the DQ list (in part due to the inability to quickly access the list). Parties assume the risk that an end buyer may be a DQ entity. Under these circumstances, a trading desk creating liquidity for loans may find itself in the unenviable position of having its end buyer be incapable of purchasing the loan by assignment or participation. Under LSTA standard terms and conditions (to which nearly all secondary BSL trades adhere), if the parties are unable to settle a loan trade by assignment or participation, the parties still remain obligated to settle the trade in a mutually agreeable alternative structure that allows the parties to obtain the economic equivalent of the trade. This unfortunate situation results in prolonging settlement and creating friction between the seller and its end buyer on the resolution of the unsettled trade.

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These issues are being compounded by the broadened scope of the DQ provisions in credit facilities. Traditionally and consistent with the LSTA market advisory, credit agreements would provide that DQ entities were limited to (1) entities that are competitors of the borrower's business and identified in writing to the administrative agent from time to time; and (2) other entities that are on a DQ list as of the closing date of the credit facility. However, **more recent credit agreements now allow for DQ lists to be updated to include not only new competitor entities after the closing date but noncompetitor entities after the closing date of the facility (such as distressed debt investors)**.

We have seen the impact of these broadened DQ provisions affecting loan market participants in litigation disputes in Serta and, more recently, Byju's. In Serta, a dispute with Apollo hinged on whether Apollo was on the DQ list at the closing of the facility or improperly added after the fact when Serta discovered that Apollo was looking to become a lender by assignment. The Apollo/Serta dispute settled before court resolution. In June 2023, educational technology company Byju's filed a complaint in New York Supreme Court challenging its lenders acceleration of a $1.2 billion term loan. Byju's sought to disqualify certain lenders from being able to accelerate the loans because they were purportedly DQ entities. Byju's maintained that the credit agreement not only prohibited assignments to buyers whose primary activity is the "acquisition of distressed debt" but also allowed for these distressed debt buyers to be added to the DQ list at any time. Byju's asserted that certain distressed debt lenders were never meant to have been allowed as lenders and that once those entities were disqualified, they were restrained from exercising rights to take enforcement actions.

Another holistic problem for market participants is the lack of recourse lenders have against administrative agents for mistakenly allowing a prospective buyer that is on the DQ list into a credit facility as an assignee. Almost all credit agreements provide that the administrative agent shall have no liability for failing to properly monitor the DQ list. Under expanded sponsor-friendly DQ provisions, borrowers have more tools to (1) try and force disqualified entities to sell their loans at either par, the price the entity paid to acquire its loan, or the market price; (2) limit DQ entities from receiving information; and (3) prohibit DQ entities from having voting/enforcement rights. It is not hard to see how exercising these expanded borrower powers could lead to significant investment losses for a buyside investor. Having limited contractual recourse against an administrative agent that fails to properly monitor the DQ list compounds the problem.

Recent litigation and **the notable increase in expanded DQ provisions for the benefit of sponsors and borrowers shed new light on the importance of loan-trading market participants to carefully review credit agreements (particularly distressed investors) before entering into trades to avoid unanticipated problems down the road**. Going in with eyes wide open for potential risks is always better than trying to rectify an unforeseen problem after it occurs.

One way to strike a fairer balance of the competing interests of borrowers/sponsors and lenders would be to make sure DQ provisions are more vigorously negotiated by lenders at the time of loan origination to establish better terms. Before the recent credit market volatility, the demand for broadly syndicated loans exceeded the supply, resulting in more leverage for borrower/sponsors to expand the breadth of DQ provisions. Now that credit is getting tighter, lenders may finally be in a position to have more bargaining power in negotiating better terms.

With the likelihood of more credits going stressed/distressed and borrowers having a challenging time with refinancing in the foreseeable future, **we can expect more situations where borrowers/sponsors will try to flex their muscles under expanded DQ provisions and limit certain buyers they believe will be difficult partners in their capital structure**. Lenders would be wise to try and use this time to shift the balance of power.

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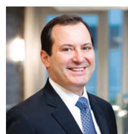

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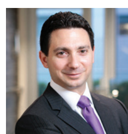

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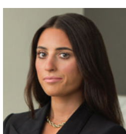

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