Feature

KEY POINTS

- Restrictions on trading of loans have traditionally focussed on excluding unwanted third parties from acquiring an economic interest in the loans.
- More recently borrowers have focussed on preventing lenders from trading out of their economic exposure instead.
- These provisions are evolving rapidly and their implications for other market participants are still not fully understood.

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Lender transfer rights: the long and short of it

In this article the authors consider the increasingly heavy restrictions on transfer rights in loan documentation in light of the expansion of the leveraged loan market and the wider implications on the financial instruments that reference these loans.

Historically, the right of lenders to transfer their interest in a loan, including to leveraged borrowers, was not a controversial topic. The principal aim of a traditional bank is to deploy its capital, receive interest, fees and repayment of principal on the loan, all the while building a long-term commercial relationship with its client. Loan agreements could indeed contain provisions enabling the lenders to transfer their participations in the future, but these were often overlooked by borrowers because they were rarely used in practice.

Over the last two decades, the leveraged loan market has developed into a €200bn asset class in Europe (and a $1trn asset class in the US), fuelled by demand from a variety of different financial entities whose goals and strategies fundamentally differ from those of commercial banks. It was only a matter of time before borrowers took note and pushed for more control over their lenders' identity.

The expansion of the leveraged loan market has caused loan arrangers to embrace an "originate to distribute" model, where the initial lenders no longer intend to take and hold an interest but rather to syndicate their participation broadly to investors who in turn expect to trade it further in a liquid secondary market. In parallel, a number of alternative asset managers, have been established with a specific focus on investing in distressed debt. This has created a demand for loans that traditional lenders may seek to dispose of when their borrower faces financial difficulties. Further, advances in the credit derivatives market have enabled loan investors to hedge their exposure (or obtain a short exposure) to a given borrower with relative ease.

Borrowers are of course not indifferent to the identity of their lenders or their incentives. For so long as the loan commitments are undrawn, or in the case of revolving facilities, borrowers take counterparty risk on the lenders, as the latter might default on their funding obligations. But even once the loans are fully funded and the commitments have expired, borrowers depend on the will of their lenders to obtain any amendment or waivers they may need to carry out actions restricted by the loan documentation, increase the amount or extend the maturity of the loans or, crucially, address a prospective breach of financial covenants. And finally, if an event of default were actually to occur, borrowers are exposed to the whim of their lenders, who are entitled to decide the timing and manner of the exercise of the remedies in their sole discretion and dictate the terms of any potential restructuring.

Borrowers have thus increasingly sought to police the manner in which these voting rights are transferred and exercised. Most of the focus so far, however, has been on restricting unfriendly third parties from going "long" on the loans and thus acquiring, directly or indirectly, an ability to influence the manner in which these voting rights are exercised, so as to ensure that the initial syndicate (or other transferees approved by the borrower) remain firmly in control.

More recently, however, borrowers have focussed their attention on the reverse side of the issue, ie on ensuring that the initial syndicate (or their approved transferees) do not go "short" on their exposure or that, if they do, they forego their ability to participate in the syndicate's collective decision making process.

RESTRICTING LONG POSITIONS

The evolution of the European market on the acquisition of an interest in leveraged loans by third parties has been the subject of much attention, due to its obvious impact on the liquidity of the secondary market. Taking as the starting point the construct reflected in the pre-financial crisis version of the LMA form of leveraged loan agreement, lenders could historically transfer their participation in loans to any other bank or financial institution provided only that they first consulted with the borrower. Further, there were no restrictions on the acquisition of sub-participations by third parties. The market position has since shifted markedly from this construct to include some or all of the following restrictions:

- The transferee must be an affiliate of an existing lender or on a pre-approved "white list".
- The transferee must not be a "defaulting lender".
- The transferee must not to be a competitor of the borrower.
- The transferee must not to be a "vulture fund", often broadly defined.
- The borrower's consent is required for any exceptions to the above, with its consent right to fall away only upon an event of default or, increasingly, only a payment or bankruptcy event of default.
- The borrower's consent right is never to fall away for transfers to members of the most objectionable of the above categories.
- The borrower's consent is not to be unreasonably withheld or, increasingly, is unqualified for transfers to members of the most objectionable of the above categories.

A controversial development in this area has been the extension of the above restrictions to sub-participations – the widely used back-to-back arrangement whereby the lender of record agrees to pass through the cash flows (and related economics and risks) of the loan to a third party, called a sub-participant, without creating a direct legal link between the sub-participant and the borrower. Such expansive language initially covered only sub-participations that transferred full voting rights to the sub-participant, but an increasing number of loan documents now include arrangements where the sub-participant merely reserves a say on fundamental changes (such as a reduction of the principal or interest

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on the loan) or, in some cases, just a consultation right. This has effectively precluded investors from acquiring an economic interest in the loans in situations where a direct transfer would have required the consent of the borrower – as a sub-participant would rarely agree to forego all control over the terms of the loans it is to indirectly invest in. In some agreements, the language has been broadened further to include any other "economic transfer" of the exposure regardless of its legal form.

HOW ABOUT THE SHORTS?

Once unwanted third parties could be kept mostly at bay thanks to these restrictions, borrowers were alerted to another threat to their lending syndicate's democracy: what if the approved lenders divested their economic exposure such that they would be indifferent to or actually benefit from a default of the borrower, or that their incentives would otherwise be fundamentally misaligned from those of the other lenders?

A number of recent high-profile controversies involving aggressive investors pushing borrowers into default while profiting from CDS or similar protection have drawn the attention of the market to these issues.

Participants realised that the limitations on acquisition of long positions by third parties described above do not necessarily preclude existing lenders from "shorting" the loans. This is because the derivative documentation through which these shorts are implemented often does not grant to the counterparty a right to influence the lenders' vote of the loans and are thus not restricted as direct or indirect "transfers" to the lenders' hedge counterparty.

As a result, specifically tailored language has started to surface in loan documentation, firstly in the US and later also in Europe to ensure that the initial lenders (or their approved transferees) maintain their skin in the game, or otherwise face consequences.

The target, so far, have been "net short" lenders, ie lenders whose exposure to the loans is more than outweighed by hedges or other short transactions; lenders, who have a fully hedged exposure (so called "basis package" lenders) or who have hedged only a portion of their loan exposure, while presenting similar issues in terms of flawed incentives, have so far escaped scrutiny. While some initial formulations sought to ban net short lenders outright, the language most often included in recent transactions seeks to police these situations broadly as follows:

- Definition: define net short lenders as those lenders who have a net short position through the use of a total return swap, total rate of return swap, credit default swap or other derivative contract. Net short position is in turn defined to take into account the notional amount of credit derivatives where the lender is a protection buyer (or equivalent), the loans are the "reference obligation" or a "deliverable obligation", or the borrower is a "reference entity" in accordance with the applicable ISDA definitions (or comparable terms under non-ISDA documentation); further, derivatives that refer to indexes are to be included if the borrower (or its instruments) represent a certain minimum percentage of the components of the index.
- Disenfranchisement: net short lenders have no right to vote their loans (and are deemed to have voted in the same proportion as lenders who are not net short lenders, so as to facilitate consents).
- Self-reporting: lenders are required to self-declare as net short lender (or otherwise are deemed to represent that they are not) at various times during the life of the loan.
- Sanctions: lenders who misrepresent their status as non-net short lenders are deemed "defaulting lenders" for the purposes of the loan documentation.

While the above construct has become common, especially in the US, various issues surrounding it remain unresolved. First, there is a debate as to whether and to what extent the short positions of affiliates of a lender should be included. Absent such inclusion the clause could be easily circumvented; on the other hand, lenders can be expected to strongly oppose it on the basis that it would create an undue diligence burden on them, as well as restrict the *bona fide* derivatives trading of other entities in their group. Participants are devising various compromises to address this issue, such as exempting affiliates that are managed independently from the lender and separated from it through information firewalls or including only affiliates that act in concert with the lenders in setting up the hedge positions.

Second, some borrowers have taken the view that vote disenfranchisement is not a sufficient remedy to net short positions and pushed for tougher sanctions to be included in the documentation. These have included:

- prohibiting any transfers of loans to entities who (after giving effect to the transfer) would be net short lenders;
- enabling the borrower to force net short lenders to sell out of the loans at par through "yank-the-bank" type mechanisms;
- even more radically, entitling the borrower to unilaterally prepay the loans held by net short lenders at par.

CONCLUSIONS

Leveraged loans have come to represent a significant asset class in the global financial system and the ability to invest in and out of them is crucial to the functioning of the market. There will continue to be an inherent tension between the desire of borrowers to police the identity of counterparties who wield important powers over their business and the liquidity expectations of loan investors and their funding sources. Recent trends have shifted the balance toward heavier restrictions. This could have yet unforeseen implications on a vast array of financial transactions, from credit insurance, to collateralised loan obligations and loan portfolio backleverages that directly or indirectly underpin the demand for leveraged loans. While demand has far outstripped supply in recent years, it remains to be seen whether and in what form these restrictions will withstand a tapering of this liquidity during the next market cycle. ■

Further Reading:

- The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times? (2018) 4 JIBFL 222.
- Preying on distressed debt: limiting the scope of transfer to vulture funds (2018) 1 JIBFL 9.
- LexisPSL: Banking & Finance: Practice Note: Key issues in loan transfers.