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Distressed Debt Investors Beware of Disqualified Lender Lists

A recent development with credit agreements is that they contain new provisions that expressly preclude “distressed investors” from holding the loans. This article aims to alert readers of the contractual language changes in these agreements and the implications of those changes.

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Creditors' and Debtors' Rights

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Secondary Loan Trading: Disqualified Lender Lists and What You Need to Know

Investors who purchase distressed debt in the secondary loan market have learned how to weather the trials and tribulations of buying bank loans. Prices fluctuate quickly and opportunities to take strategic control of financially distressed companies are few and far between.

Distressed debt investors typically purchase bank loans as an asset class to diversify investments, for arbitrage or for strategic purposes. While there are a number of barriers to entry in this asset class, one obstacle has grown increasingly burdensome over time—disqualified lender lists or blacklists. Such lists are generated by borrowers to prevent certain types of entities from buying the borrower's debt.

These lists, known colloquially in the trading market as "DQ lists," are not new, but market participants are oftentimes surprised to find their names on a DQ list. Ignoring the DQ list comes with a heavy price—the trade can be deemed null and void.

So, what's a distressed investor to do? Ordinarily, the process for buying distressed debt on the secondary market is fairly straightforward with the use of proper legal counsel. Syndicated credit agreements generally permit loans to be assigned.

Before purchasing a bank loan, an investor and its counsel must review the credit agreement and understand the transfer requirements and restrictions. A transfer clause, often referred to as the "successors and assigns" clause in the agreement's table of contents, provides a road map for an existing lender to sell all or a portion of a bank loan to a new lender.

The transfer clause is an intricate part of a credit agreement to be navigated carefully as it contains vital details and procedural requirements. There are almost always requirements to pay the transfer agent a transfer fee of $3,500, a minimum transfer amount for the loans, the requirement for the borrower to provide consent to the transfer unless there is an event of default, and detailed withholding tax requirements. The form of assignment agreement is also affixed as an exhibit to the credit agreement. The transfer clause and the form of assignment agreement require a thorough review.

Since the transfer clause is placed near the end of the credit agreement, it is often overlooked. This is a potential problem because the transfer clause dictates what the lender can and cannot do, including identifying a list of permitted entities that can receive loans by assignment. The transfer may be deemed null and void if the transfer is in violation of the transfer clause.

Permitted transferees or assignees are often referred to as an "eligible assignee" or an "eligible lender." These are defined terms in a credit agreement and a prospective investor must review the defined terms to ensure that they can in fact meet the requirements. An "eligible assignee" may be defined as including an existing lender, an affiliate of an existing lender or any commercial bank, finance company, finance institution, or any fund that invests in loans or any other "accredited investor" (as defined in Regulation D of the Securities Act). The definition almost always precludes natural persons, defaulting lenders and certain disqualified parties.

Embedded in the terms for permitted transferees are terms for prohibited transferees. Terms often used to refer to prohibited transferees include: disqualified lenders, disqualified institutions, distressed funds and ineligible institutions. Such disqualified parties often include company competitors. Borrowers prevent these parties from purchasing its debt because borrowers do not want certain entities, such as a top competitor, to have access to the borrower's financials.

Borrowers also seek to exclude certain investors with loan-to-own strategies. Recent credit agreements have included a borrower's right to withhold consent if the borrower knows or believes that the potential new lender is engaged in distressed investing, special situations or opportunistic loan trading. This means that a new lender may not even appear on a DQ list, but still may be denied consent solely because the borrower believes the potential lender's principal investment strategy involves distressed debt or other investment strategies to acquire ownership or control.

These broad restrictions are relatively new in the distressed market and are appearing both in new and amended credit agreements. The broad wording of such provisions gives the borrower greater discretion and control over its lender group in a way that even the most diligent investor will not be able to anticipate, making it difficult to learn who is on the DQ list and who is not.

Perhaps even more daunting is that access to these DQ lists has proven difficult. Emails to agents go unanswered and an investor may be buying blind, a dangerous strategy if the investment is deemed null and void, with the borrower demanding that the agent unwind the transaction. If that occurs, the best-case scenario for the investor is to be removed at par; however, more likely the investor is removed at the current trading price of the loan, which could result in a loss.

The worst-case scenario for a distressed investor is being retroactively added to a DQ list. Typically, a credit agreement will state that the borrower or an administrative agent can add a lender to a DQ list; however, such restriction does not retroactively apply to the lender if the lender previously invested in the loan. It could be costly for an investor to be retroactively added to a DQ list and removed from a deal. An investor should always be able to review the DQ list to ascertain if it is on the list.

If the lender cannot obtain a copy of the DQ list, the lender should ask the agent if the lender's name appears on the list. Oftentimes, a credit agreement will provide that it is not the administrative agent's responsibility to check if a potential transferee is on the DQ list and the administrative agent further disclaims all liability with respect to an investor being on the DQ list. An investor should always try to first obtain a copy of the DQ list and second, ask the administrative agent if its name appears on the DQ list.

In summary, the secondary loan market is seeing a critical shift in transfer terms which are trending toward further limitations for certain distressed investors to purchase bank loans. Now, more than ever, it is imperative to closely examine the transfer provision in loan agreements, the relevant defined terms, form of assignment agreement and any other related credit documents.

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