Client Alert

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Recent Credit Agreement Restricts Ability of CLOs to Pledge Loans and Ability of Lenders to Sell Participations on the LSTA Form

By Michael Fransella

A broadly-syndicated U.S.-law credit agreement[1] which closed recently includes language limiting the ability of lenders to grant pledges or sell participation interests in their loans. The language appears to be intended to prevent pledgees and participants from gaining direct rights under the credit agreement, but goes beyond provisions that are customary in the market by attempting to (i) prevent participants from gaining beneficial ownership of the participated loan and (ii) preventing participants and pledgees from obtaining direct ownership of the loan even in the event of the insolvency of the grantor or pledgor. Although this language may be ultimately unenforceable, by its terms it could prevent a collateralized loan obligation fund (CLO) from effectively pledging its loans to its trustee, and cause a lender that sells a participation interest using the forms promulgated by the Loan Syndications and Trading Association (LSTA), or any other form that effects a "true sale," to be in non-compliance with the credit agreement. Collateral managers of CLOs, and market participants intending to sell or buy participation interests, should review pledge and participation provisions of recent credit agreements closely to confirm that they do not contain language that could be breached by, or could frustrate, ordinary market practices and expectations.

PLEDGES BY CLOS

A defining feature of a CLO is that it grants a security interest in its portfolio of loans and other assets to its trustee, for the benefit of the holders of its notes. Frequently, the collateral manager is contractually obligated to ensure that the trustee holds a perfected, first-priority security interest in the CLO's portfolio. The ability to effectively pledge may also be a requirement under the CLO's indenture in order for a loan to be eligible to be purchased by the CLO. To accommodate CLOs (as well as banks that pledge their loans to a Federal Reserve Bank), most credit agreements that are marketed to the U.S. loan market (and an increasing proportion of European credit agreements) include language explicitly permitting pledges without any consent or notice requirement.

The market-standard language permitting pledges states that a pledge does not substitute the pledgee for the grantor as a "Lender" with direct rights under the credit agreement. This language prevents the pledge provision from swallowing the consent, documentation, minimum-transfer, and other requirements for assignment under the credit agreement. The credit agreement in question, however, goes beyond this standard caveat by adding that the pledgee will not gain direct rights even upon the insolvency of the pledgor.

[1] Because the credit agreement in question is not public, we are not able to specifically identify it.

How exactly this language would play out in the event of a CLO insolvency is unclear. An applicable court could conclude that a properly-perfected pledge is effective and order the borrower and administrative agent to pay the trustee directly, notwithstanding the credit agreement language suggesting otherwise, particularly if the CLO is to be liquidated and will not be in a position to pass on payments. New York[2] case law supports the conclusion that, unless an agreement explicitly states that non-complying transfers are null and void (which the credit agreement in question does not), such transfers are effective conveyances. Moreover, Uniform Commercial Code Section 9-406(d) arguably overrides contractual restrictions on the pledge or other transfer of loan interests, and any breach-of-contract claim arising from non-compliance with such restrictions. There is no guarantee, though, that a court would not conclude that the credit agreement provisions are enforceable or otherwise rule in a manner that effectively prevents the trustee from foreclosing on its pledge. In addition, whatever the outcome of the analysis with respect to payments and ownership, the question of whether the trustee would be able to exercise direct voting rights could be analyzed independently, and that analysis could yield a different result.

Even if the trustee might ultimately be able to take ownership of the loan, the language in question casts enough doubt that a collateral manager might reasonably question whether it can cause the CLO to purchase the loan and remain in compliance with its obligation under its collateral management agreement to ensure that the trustee maintains a properly-perfected security interest (as well as any analogous provisions of the CLO's indenture).

PARTICIPATION INTERESTS

In the U.S. market, participation interests are usually structured to be "true sales" of the underlying loan. From a legal perspective, this means that the participant becomes the beneficial owner of the loan and can, in the event the seller becomes insolvent, extract the participated loan from the seller's insolvency estate, dollar-for-dollar. From an accounting perspective (which, under U.S. GAAP, generally depends on the legal conclusion), a true sale means that the seller can take the loan off its balance sheet. Most U.S. credit agreements accommodate participations by including language which specifically states that lenders may freely sell participations, subject only to minor restrictions (e.g., participants can only vote on matters that would require unanimous consent of all lenders or the consent of each affected lender, participations may not be sold to borrower competitors or affiliates). The LSTA forms of par and distressed participation agreement, which would be the market-standard forms of participation agreement for a New York-law, syndicated commercial loan facility such as the credit agreement in question, are structured so as to effect true sales of the underlying loans under New York law, as were the customary participation forms that preceded standardization by the LSTA.

This credit agreement, however, states explicitly that a participation may not convey to the participant any interest in the underlying loan, and must be structured as a debt obligation of the seller. This directly contradicts the language of, and would therefore by its terms bar the use of, the LSTA forms. The restriction may ultimately be unenforceable, both due to the absence from the credit agreement of language stating that non-complying transfers are null and void (which, as noted above, may be necessary to prevent a non-complying transfer from becoming effective under applicable case law) and due to the "override" provisions of UCC Section 9-406(d). Nonetheless, lenders who expect to be able to sell participation in broadly-syndicated U.S. commercial loans, but who have not reviewed the specific provisions of this credit agreement closely, may find themselves in the

[2] The credit agreement in question is governed by New York law.

position of having violated the credit agreement as written by entering into an LSTA participation agreement.

CONCLUSION

CLO managers, and market participants that may sell or buy by participation, should be careful to ensure that they have not recently purchased any loans that match the description contained herein (or, if they have, that the language in question has been fully vetted by internal or external counsel). They may also wish to increase their diligence of the pledge and participation provisions of credit agreements going forward, in case the problematic language spreads to other deals.

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