Professional Perspective

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Competitors & Disqualified Institutions: Considerations & Sample Provisions

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For borrowers under all types of credit facilities, the identity of the institutions providing credit, and those entities' access to the borrower's confidential information, is of paramount importance. Similarly, for the lenders providing credit, the ability to reduce or eliminate their exposure, particularly for troubled credits, is critical and has been increasing in importance due to capital constraints, bank failures and sustained higher interest rates.

An important consideration in these competing concerns is what constitutes a "competitor" of the borrower and in which circumstances—if any—a competitor should be allowed to be a lender—or participant of a lender—in a credit facility. Assignment and participation provisions are standard in credit agreements but have recently been under much greater scrutiny and negotiation, including as it relates to the ability of a lender to sell to a competitor.

This article will provide a summary of the more common constructs for restrictions on a lender's ability to sell its interest in a credit facility to a competitor.

Lender Assignments & Participations

A lender that would like to reduce its exposure under a particular credit facility may decide to do so by either assigning all or a portion of its loans and commitments to another lender or entering into a participation agreement whereby the lender sells an interest in its loans to a third party. In an assignment, the assignee steps into the assignor's shoes and becomes a party to the credit agreement. The assignee thus has a direct contractual relationship with the borrower and assumes the assignor's rights and obligations under the credit agreement.

In a participation, by contrast, the participant only has a contractual relationship with the selling lender. The selling lender passes along the economics of the transaction to the participant, but the selling lender remains responsible for fulfilling its contractual obligations under the credit agreement such as funding obligations to the borrower and indemnification obligations to the administrative agent.

When negotiating a credit agreement, lenders want to limit any restrictions on their ability to assign or sell a participation in a loan. Conversely, borrowers negotiate for tight restrictions on who may acquire an assignment or participation, which is where the prohibition on selling to a competitor comes into play.

Successor & Assign Provisions

Most syndicated credit agreements—including the Loan Syndications & Trading Association's model form for investment grade term loan and revolver—include a section governing a lender's right to assign or sell participations in all or a portion of its rights and obligations under the credit agreement. Restrictions on assignments are included in the successor and assign provisions in the credit agreement —typically in the "Miscellaneous Provisions" section.

These provisions provide that no assignment may be made, or participation sold, to certain parties outlined in more detail below. In addition, for assignments to a person other than an existing lender under the facility—or an affiliate thereof—credit agreements typically require the consent—not to be unreasonably withheld, conditioned or delayed—of the administrative agent and, in most circumstances outside of an event of default under the credit agreement, the borrower.

Consent of the administrative agent is typically necessary for lender assignments because the administrative agent may have fronting exposure for certain types of loans and for letters of credit and also because lenders typically have indemnification and reimbursement obligations to the agent. At a minimum, the administrative agent needs notice of assignments in order to administer borrowings and payments under the credit facility.

For participations, however, the standard market practice is to permit lenders to sell participations without any consent of—or notice to—the borrower or the administrative agent. This approach with respect to participations makes sense because the selling lender is only transferring certain economic rights with respect to its loans and commitments, and it remains contractually liable to the borrower and administrative agent.

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Below are a few examples of how the restriction on a lender's ability to sell assignments or participations may appear in a credit agreement—and how clause (iv) of the provision may be drafted in a variety of ways:

> **No Assignment to Certain Persons.** No such assignment shall be made: (i) to a Credit Party or any Affiliate or Subsidiary of any Credit Party; (ii) to any Defaulting Lender or any of its Subsidiaries, or any Person who, upon becoming a Lender hereunder, would constitute any of the foregoing Persons described in this ***clause (ii)***; (iii) to a natural person; or
>
> (iv) to any hedge fund, credit fund, private equity fund or any investment advisor to any such fund.
>
> (iv) to any hedge fund, credit fund, private equity fund or any investment advisor to any such fund that invests in real property or commercial or industrial real estate.
>
> (iv) to any Competitor.
>
> (iv) to any Disqualified Institution.
>
> (iv) to any Ineligible Institution listed on Schedule IV.

The construct used for restrictions on a lender's ability to sell a participation to a particular entity (or entity with certain characteristics) typically tracks the restrictions on assignments.

Competitor Constructs

If the parties agree to restrict assignments or participations to competitors, the definition of "competitor" is often highly negotiated, with borrowers pushing for an expansive definition and lenders wanting a clear and narrowly-tailored description, often including a list of specifically named entities. What follows is an example of a very broad, borrower-friendly definition that is very restrictive to lenders:

> "***Competitor***": (i) any Person that is a *bona fide* direct competitor of the Borrower or any of its Subsidiaries in the same industry or a similar industry which offers a similar product or service as the Borrower or any of its Subsidiaries and (ii) any Affiliates of such Person that are reasonably identifiable on the basis of its name.

The broadness and ambiguity of this definition make it challenging for a lender to know whether a particular purchaser of the debt would qualify as a competitor. For example, if a borrower sells medical devices for hip bone replacements, is the industry the "healthcare industry," the "medical devices industry," the "hip bone replacement industry", or something else? Adding to this ambiguity are questions about whether one industry is "similar" to another and how to account for borrowers that are active in multiple related or unrelated industries. This construct also puts the burden on the lenders to determine whether a potential purchaser is a competitor.

The definition may be narrowed by identifying the competitor's specific business, thus removing some of the ambiguity present in the prior definition:

> "***Competitor***" means any fund, hedge fund or investment vehicle engaged in the business of making investments (whether in the form of debt or equity) in real property or commercial or industrial real estate, including investments in businesses and/or assets in the construction sector, but excluding commercial banks.

The identified strategy or line of business of the competitor may be further refined by adding a materiality concept such that such strategy or line of business needs to be a material part of the competitor's overall business mix:

> "***Competitor***" means any fund, hedge fund or investment vehicle that, as a material part of its investment program, regularly makes portfolio investments in real property or commercial or industrial real estate, including investments in businesses and/or assets in the construction sector, but excluding commercial banks.

Alternatively, the ambiguity in a very broad, borrower-friendly definition of competitor may be lessened by adding a knowledge qualifier providing that the lender has to have *knowledge* of the competitor. But another burden (at least in this example) is added to the assigning lender to make "due inquiry" (which, itself, is ambiguous):

> "***Competitor***" means any Person who is a competitor of the Borrowers if Administrative Agent and/or the assigning Lender has actual knowledge (after due inquiry) of the foregoing.

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Moving further along the spectrum of competitor formulations to a more lender-friendly construct, the definition of competitor may include a specific list, either in the form of a schedule to the credit agreement or a writing provided to the administrative agent:

> "***Competitors***" shall mean competitors of the Borrower or any of its Subsidiaries that are in the same or a similar line of business and, in each case, identified in writing to the Administrative Agent from time to time.

Disqualified Institution Constructs

Of course, it is possible for a credit agreement to effectively restrict assignments or participations to a competitor without having a defined term "Competitor" included in the agreement. As shown in the initial example above, there may be a generic restriction to any other hedge fund without the use of any defined terms. The terms "Disqualified Institution", "Disqualified Lender", "Eligible Assignee", "Eligible Institution" and "Ineligible Institution" may incorporate the concept of a competitor.

As with the definitions of "Competitor" discussed in this article, these other terms will range from broader definitions, favorable for borrowers, to narrower definitions, favorable for lenders. In some credit agreements the parties agree to include a specific list of those entities to whom an interest in the loan may not be sold.

In certain situations, the administrative agent and lenders may be able to negotiate for an approval right for this list identified by the borrower. The approval rights in these provisions range from approval of the administrative agent only, to required lenders, to all lenders. Examples of such defined terms are as follows:

> "***Disqualified Institution***" means any Person that is (i) identified in writing by the Borrowers and approved by the Administrative Agent and the Arranger on or before the Closing Date, (ii) identified in writing by the Borrowers and approved by the Administrative Agent and Required Lenders from time to time after the Closing Date, or (iii) an Affiliate of the Persons described in the preceding clauses (i) or (ii) that is either (a) identified in writing by the Borrowers from time to time or (b) clearly identifiable on the basis of such Affiliate's name.
>
> "***Ineligible Institution***" means the Persons identified on Schedule IV and any additional Persons from time to time agreed to by all of the Lenders and the Borrowers.
>
> "***Disqualified Lenders***" means:
>
> (a) those Persons identified by Borrower or the Sponsor to the Lead Arranger in writing on or prior to the date of the Commitment Letter;
>
> (b) any Competitor that is identified in writing (which list of Competitors may be supplemented by the Borrower after the Effective Date by means of a written notice to the Administrative Agent, but which supplementation shall not apply retroactively to disqualify any previously acquired assignment or participation in any Loan); and
>
> (c) any Affiliate of any Person described in clauses (a) and (b) above (other than any "Competitor Debt Fund Affiliate") that is either identified in writing to the Administrative Agent or readily identifiable on the basis of such Affiliate's name;
>
> it being understood and agreed that the identification of any Person as a Disqualified Lender after the Effective Date shall not apply to retroactively disqualify any previously acquired assignment or participation interest in any Loan.

These provisions, which are used by borrowers—and/or their sponsor owners—to block what they deem to be "loan to own" or otherwise predatory—or simply difficult—institutions from becoming lenders, can also be used to block competitors and, unless certain qualifications and conditions are met, the lending affiliates of competitors as well.

Parties sometimes include a carve out from these disqualified lists for "Competitor Debt Fund Affiliates", which are entities regularly engaged in the making of loans and other extensions of credit and have sufficient separation of management and access to information such that personnel involved in the investment decisions of the competitor fund would not have access to the confidential information or the ability to influence the decisions of the "Competitor Debt Fund Affiliate".

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Triggering Events for Removal of Restrictions

If there is a restriction on assigning or selling participations to certain parties, the restriction will sometimes fall away after the occurrence of triggering events, such as the occurrence of an event of default—or certain types or "specified" events of default. The lender's view is that once an event of default has occurred—or certainly if a more serious type of an event of default has occurred, such as a payment, insolvency or bankruptcy event of default—any restriction should terminate and lenders should be able to freely trade the debt of a non-performing credit party.

Borrowers, of course, will negotiate to narrow the events of default and/or provide that the event of default has to have occurred and continued for a certain number of days. Borrowers argue that a default scenario is when the restriction on selling to a competitor is most important, as there is a risk that competitors could try to come into the deal and push for an exercise of remedies against the borrower in the furtherance of business objectives unrelated to the specific credit facility.

Looking back at clause (iv) from the initial example, the clause could be tailored in a number of ways, starting with the most lender-friendly:

> (iv) any Competitor, unless an Event of Default has occurred and is continuing, in which case such assignment may be made to a Competitor.
>
> (iv) any Competitor, unless an Event of Default has occurred and remains uncured for thirty (30) days or longer.
>
> (iv) any Competitor, unless (x) an Event of Default then exists under *Section [payment default]*, *Section [voluntary bankruptcy]* or *Section [involuntary bankruptcy]* or (y) any other Event of Default has occurred and has not been cured within sixty (60) days of such occurrence.
>
> (iv) any Competitor, unless an Event of Default then exists under *Section [payment default]*, *Section [voluntary bankruptcy]* or *Section [involuntary bankruptcy]*.

Consequences of an Assignment to a Competitor (or other Disqualified Institution)

Credit agreements generally place the burden of complying with any prohibitions on assignments to competitors on the parties to such assignment, rather than on the administrative agent. Accordingly, most credit agreements expressly state that the administrative agent is not responsible for enforcing the provisions regarding disqualified institutions. That approach then leaves open the question of what happens in the event that an assignment is made to a competitor or other disqualified institution in violation of the applicable prohibitions.

The predominant approach is to state that the assignment itself is not void but to give the borrower the ability to elect to remove the disqualified institution upon notice to the disqualified institution and the administrative agent. The rationale against an assignment being void is that it could be exceedingly difficult, if not practically impossible, for the administrative agent to undo the assignment after it has occurred—potentially weeks, months or years later—for a few reasons.

Most notably, the administrative agent would need to recoup any funds previously paid to the disqualified institution, to recalculate the correct amounts that should have been paid to the parties to the credit facility and to make true-up payments where appropriate. This could be a very long and complex process. Also, this could create ambiguity concerning the validity of any amendments, consents and waivers that were passed during the period when the disqualified institution was in the deal.

Borrowers often have the right to remove disqualified institutions through (1) the termination of any revolving (or other unfunded) commitments of the disqualified institution and the repayment of all outstanding obligations held by the disqualified institution (in the case of any outstanding term debt, at the lower of par and the amount that the disqualified institution paid for such loans) and/or (2) a forced assignment from the disqualified institution to another institution that meets the requirements for being an eligible assignee under the applicable credit agreement. Once identified as an assignment that should not have been made, credit agreements often provide that confidential information can no longer be shared with the disqualified institution that was the assignee under the applicable assignment.

Borrowers sometimes argue that this "repayment or assignment" approach is not a satisfactory remedy for dealing with disqualified institutions that have come into their deal; however, no other approaches have gained a significant level of market acceptance.

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Conclusion

Prior to the third and fourth quarters of 2022, the low interest rate environment and looser capital requirements gave borrowers more leverage to negotiate for tight restrictions on assignments and participations in their credit facilities. In the current environment of higher interest rates and tight capital requirements, lenders are more focused on maintaining liquidity and the ability to trade and/or sell their positions in loans. Even if a lender is not planning to assign or sell a participation in its position in a loan, the parties should put energy into negotiating provisions that will allow all parties to have the appropriate amount of protection and flexibility for a given transaction.

The uncertainty of the economic outlook in the year ahead is even greater reason to take the time to review these "boilerplate" provisions. If we have learned anything from 2023, it is to expect the unexpected.

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