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LSTA's Revised Trading Documents Allow Revolver Loan Investors to Protect Their Posted Collateral — But Only If They Ask

LAWRENCE V. GELBER, DAVID J. KARP, AND ERIK SCHNEIDER

The authors review changes made by the Loan Syndications and Trading Association to its Collateral Annex for Loan Participations and LSTA Par and Distressed Trade Confirmations.

On June 28, 2013, the Loan Syndications and Trading Association (“LSTA”) announced that the revised Collateral Annex for Loan Participations and revised LSTA Par and Distressed Trade Confirmations became effective. The revisions to the LSTA’s suite of documents have improved the ability of investors in revolver loan participations to protect themselves against the lender of records’ insolvency risk. Investors face this risk when they are required to post collateral with the lender of record to support their obligations to fund the borrower’s future draws on the revolving loan under the participation agreement. The revisions to the LSTA’s documents include, among several other changes:

- a check-the-box option that allows collateral to be segregated with the seller or a third-party custodian;

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- a revised formula to calculate the amount of collateral required; and
- more frequent triggers for the seller to return any excess collateral.

These revisions make it even more important for investors in revolver loans to negotiate these points at the time of the trade. If investors later have to settle a revolver loan trade by participation instead of by assignment, they may lack the leverage to negotiate the appropriate protections for their collateral. In addition, buy-side funds that frequently invest in revolvers may want to consider negotiating account control agreements with third-party custodians and each of their most frequent sell-side counterparties, if they are concerned about their sellers' credit risk.

THE LSTA COLLATERAL ANNEX IN PRACTICE — BUYERS FACE ADDITIONAL CREDIT RISK DUE TO COMINGLING OF COLLATERAL

The LSTA Collateral Annex is generally used when a trade for a revolving loan or commitment settles by participation instead of by assignment because the borrower did not consent to the assignment. Borrowers often have the right to consent to assignments of their revolver loans, even if they do not have consent rights with respect to assignments of term loans. Historically, borrowers have been reluctant to consent to an assignment of a revolving facility to investment funds because they (justified or not) are concerned with an investment fund's ability to fund their draws as reliably as a banking or similar financial institution. When a trade settles as a participation, the revolver lender remains obligated to the borrower to fund any future draws; however, under the participation agreement, the buyer is required to pay its share of any of the borrower's future draws to the revolver lender. On account of that same concern, revolver lenders that participate a piece of their revolver loans to an investment fund have typically required investment funds to post collateral with the revolver lender to secure their funding obligation under the participation agreement.

The LSTA's prior version of the Collateral Annex provided that the buyer would post its collateral into a comingled account with the seller and permit-

ted the seller to freely transfer, assign, invest, commingle, hypothecate, pledge or otherwise dispose of the buyer's collateral. As a result, if the seller were to become subject to a bankruptcy case or other insolvency proceeding (e.g., under SIPA or as part of an FDIC receivership), the buyer would not have any security interest or any other property right in the specific collateral it posted with the seller, even though the collateral was the buyer's property (unless and until the buyer defaults on its obligations). Effectively, the buyer's posted collateral would have dissipated into the seller's bankruptcy or receivership estate, and the buyer would only have an unsecured claim for the posted collateral against the seller's estate. Adding insult to injury, if there was a draw after the seller's insolvency, the buyer would remain obligated to fund the full amount — irrespective of the collateral it had posted.

LSTA'S REVISED COLLATERAL ANNEX

The LSTA's prior version of the Collateral Annex was published in 2008 and was due for an update in light of the Lehman Brothers and MF Global bankruptcies and increasing global regulatory focus on collateralization of derivative transactions, which has resulted in a number of new initiatives, including Dodd-Frank's provisions requiring collateral segregation (in the case of bilateral, unsecured swaps) and increased margin requirements. After close to a year of negotiations in the LSTA's Trade Practices and Forms Committee, the revised Collateral Annex, Par Trade Confirmation and Distressed Trade Confirmation include the following changes:

- Trade Confirmations
 - Includes: (i) a check-the-box option for segregation of collateral if the collateral account is established with the seller; and (ii) a further option to establish the collateral account with a third-party custodian.
 - Note that if neither of these options is *agreed to at the time of trade*, the default is for the collateral to be posted with the seller in a commingled account.
- Collateral Annex

- Allows for segregation of collateral with the seller, or with a third-party custodian (depending on what was agreed to in the trade confirmation).
- Two alternative formulas to calculate any collateral shortfall or collateral excess:
 - Option one is based on a percentage of the amount of unfunded commitments; and
 - Option two differs from option one by also taking into account the market value of the participation (subject to a haircut).
- Increased frequency of refunding excess collateral — changed from quarterly upon buyer's demand, to monthly, after revolver pay-downs and after draws, subject to the buyer and the seller negotiating the exact timing of payments.
- If the seller maintains the collateral account, it must provide monthly statements.

THE LSTA COLLATERAL ANNEX IN FUTURE PRACTICE

With these revisions, the LSTA has taken steps in bringing its suite of documents up to date given the current regulatory environment and credit-risk-conscious market. However, far from defaulting to options protecting buyers' rights in its collateral, the LSTA's revised Collateral Annex and the related check-the-box options in the trade confirmations merely give buyers the option to negotiate these terms with their seller. As a result, it is now even more important for buyers to educate their trading and operation personnel on these options so that these can be dealt with upfront at the time of trade. Neglecting to negotiate these points early in the life of a trade may result in sellers refusing to entertain any discussions of collateral segregation when these issues become pertinent.

Additionally, the LSTA's revised Par and Distressed Trade Confirmations contain a cautionary footnote that effectively discourages parties from opting for establishing a segregated collateral account with a third-party custodian if there is no agreed-upon control agreement in place. This footnote's language

arguably allows sellers to refuse to agree to any third-party custody arrangement until they have agreed to a control agreement. As a result, prudent buyers that are concerned about minimizing their exposure to counterparty credit risk under the LSTA's Collateral Annex should take immediate steps to negotiate a control agreement and be better positioned to segregate collateral with a third-party custodian for their revolver trades, if they so choose.

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