
Hughes Hubbard & Reed

Developments in Leveraged Finance — Know Thy Lender

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Nov. 12, 2025 — “Know thy enemy” is often attributed to Sun Tzu, who famously advised “[i]f you know the enemy and know yourself, you need not fear the result of a hundred battles.” Centuries later, as many of us with sophisticated music tastes will know, Green Day released its popular single, “Know Your Enemy,” which was the first song to top the “Rock Songs,” “Alternative Songs” and “Mainstream Rock” Billboard charts at the same time. (Even those of us without sophisticated music tastes may recognize the theme song for “WWE SmackDown” used between 2010 and 2012.) As a tribute to Sun Tzu (and relatedly, Green Day), the author characterizes a borrower’s interest in knowing its lending syndicate as “Know Thy Lender.”

Credit markets continue to evolve, with borrowers effectuating “liability management transactions” to de-lever, generate additional liquidity, prolong maturity dates and otherwise create a runway to managing upcoming debt maturities.¹ Concurrently, creditors are forming “co-ops” in which they “unite with the goal of obtaining a favorable restructuring transaction with a stressed or distressed company to restructure the company’s indebtedness.”² In light of these developments and related judicial decisions,³ sophisticated borrowers and their private equity sponsors are taking a fresh look at provisions that permit the loans to trade to debt investors.

This article explores recent developments in the leveraged financing markets related to the Know Thy Lender provisions.

Refresher on Assignments

New York law distinguishes between a party’s **right** to assign and its **power** to assign. The model credit agreement provisions published by the Loan Syndications and Trading Association (the LSTA form) include language (the LSTA Provision) prohibiting a party’s **power** to assign⁴ and in any event requires the consent of the borrower for any assignment by a lender, subject to an exception for assignments to existing lenders and their affiliates and to suspension of such consent right upon the occurrence of certain events of default (to be specified by the lending institution).⁵ In addition, the LSTA form includes a three-business-day “deemed consent” period, meaning that if a borrower fails to object to the assignment during such period,⁶ the borrower is deemed to consent to the assignment. All such provisions are highly negotiated between sophisticated market participants; most private equity sponsors have forms reflecting their preferred approach on such provisions.

Voting Caps

Voting caps are not new. It is well established in the market that bona fide debt fund affiliates of a private equity sponsor may hold loans of a portfolio company without limitation, subject to amounts held in excess of 49.9% of the loans (and lending commitments) being disregarded for purposes of voting. Voting limitations imposed on affiliates of the private equity sponsor are generally more restrictive, with such affiliates either being disenfranchised or deemed to vote pro rata in accordance with nonaffiliate lenders. In addition, such affiliates grant a power of attorney to the administrative agent to vote on behalf of such affiliate in bankruptcy-related matters (subject to narrow exceptions).

What about voting caps on third-party debtholders? In February, Bloomberg noted the inclusion of a 20% voting cap on individual debtholders, regardless of the debtholders' stake.⁷ An example of such provision is as follows:

*Notwithstanding anything to the contrary in this "Amendment, Supplement and Waiver" section, the "Events of Default and Remedies" section, the definition of "Required Holders" or otherwise in the Indenture, for purposes of determining whether the Required Holders or any of the Holders, as applicable, have (i) consented (or not consented) to any amendment, modification, waiver, consent or other action with respect to any of the terms of the Indenture with respect to a Series of Notes, the Notes of such series, the Guarantees of such series or the Security Documents with respect to such series or any departure by the Issuers or any Guarantor therefrom, (ii) otherwise acted on any matter related to the Indenture with respect to a Series of Notes, the Notes of such series, the Guarantees of such series or the Security Documents with respect to such series or (iii) directed or required the Trustee or any Holder to undertake any action (or refrain from taking any action) with respect to or under the Indenture with respect to a Series of Notes, the Notes of such series, the Guarantees of such series or the Security Documents with respect to such series, **all Notes held or beneficially owned by any Holder (or beneficial owner) or any Affiliate of such Holder (or beneficial owner), shall not, subject to the proviso to this paragraph below, account for more than 20.0% of the Notes of a Series outstanding at any time (with respect to any Holder (or beneficial owner) (collectively with any Affiliates of such Holder (or beneficial owner))), the "Voting Cap")** included in determining whether the Required Holders or any of the Holders, as applicable, have consented to any action (or refrained from taking any action) or provided any consent or waiver pursuant to this "Amendment, Supplement and Waiver" section. All Notes held or beneficially owned by any Holder (or beneficial owner) or any Affiliate of such Holder (or beneficial owner) in excess of the Voting Cap shall be deemed to not be outstanding for all purposes of calculating whether the Required Holders, or with respect to any other action which requires the consent of the Holders, the Holders, as applicable, have taken any action (or refrained from taking any action) or provided any consent or waiver; provided that, notwithstanding the foregoing, the Issuer may, in its sole discretion, consent to an increase of the Voting Cap for any individual Holder (or beneficial owner) (collectively with any Affiliates of such Holder (or beneficial owner)) from time to time, which increase shall become effective with respect to the Voting Cap solely for such Holder (or beneficial owner) (collectively with any Affiliates of such Holder (or beneficial owner)) (and not, for the avoidance of doubt, with respect to the Voting Cap for any other Holder (or beneficial owner) or the Affiliates of any other Holder (or beneficial owner)) upon written notice to the Trustee.⁸*

At time of publication, Bloomberg noted that such provision had been included in two deals for the same top-tier sponsor.⁹ One commentator prophetically noted that "[o]nce these provisions make their way into some documents, they will quickly spread more widely."¹⁰ By Labor Day, such prophecy had come true. As one head of executions at a leading private credit platform noted to the author, in response to actions taken by certain market participants extracting value from performing borrowers, sponsors are increasingly asking for either a 20% cap on voting rights for individual debtholders or an unfettered consent right for any individual debtholder to hold more than 20% of a tranche of debt. While it is too soon to refer to such provisions as being "market," sophisticated borrowers, arrangers in the broadly syndicated markets and private credit funds providing direct lending solutions should be prepared to address this Know Thy Lender protection.

Expansion of Borrower Consent Rights to Assignments

The LSTA first published modifications to the LSTA Provision relating to treatment of entities prohibited from owning a borrower's loans (the LSTA DQ Structure) in 2014, with subsequent modification in 2022.¹¹ At its core, the LSTA DQ Structure is designed to provide borrowers and their private equity sponsors with the ability to exclude certain entities from a lending structure, whether due to relationship concerns, competition or otherwise.

The LSTA definition is as follows:

*"Disqualified Institution" means (a) any Person designated by the Borrower as a "Disqualified Institution" by written notice delivered to the Arranger on or prior to [date of the Commitment Letter], (b) any other Person that is a Competitor of the Borrower or any of its Subsidiaries, which Person has been designated by the Borrower as a "Disqualified Institution" by written notice delivered to the Administrative Agent from time to time and (c) as to any entity referenced in either of clauses (a) and (b) above (the "Primary Disqualified Institution"), any of such Primary Disqualified Institution's Affiliates designated by the Borrower by written notice delivered to the Administrative Agent from time to time or otherwise reasonably identifiable as an Affiliate of a Primary Disqualified Institution solely on the basis of the similarity of such Affiliate's name to the name of any entity set forth on the DQ List, but excluding any Bona Fide Debt Fund.*¹²

Throughout the years, credit agreements have imperfectly adapted the LSTA DQ Structure. The LSTA designed the LSTA DQ Structure to promote efficiency in the liquid loan markets. Private equity sponsors, however, adapted such structure to promote their interest in excluding certain market participants from lending syndicates. Lenders, including private credit funds providing direct lending solutions in the middle market, adapted the LSTA DQ Structure to fall away after the occurrence of one or more events of default on the theory that the loans should be freely tradable once the borrower is no longer performing. Accordingly, "market" is highly dependent on the size of the borrower, the nature of the financing it is obtaining and the prominence of its private equity sponsor.

Recent deals for top-tier sponsors include language that either expands the definition of "disqualified institution" or includes additional categories of institutions to which the borrower can prohibit an assignment, regardless of whether an event of default has occurred and is continuing. An example from a recent, unreported deal is as follows:

... the prior written consent (such consent not to be unreasonably withheld, conditioned or delayed, except in connection with a proposed assignment to any Disqualified Institution) of: (A) the Borrower; provided, that no consent of the Borrower shall be required for an assignment of all or a portion of the Term Loans (i) to a Lender, an Affiliate of a Lender or an Approved Fund thereof, (ii) if a Specified Event of Default has occurred and is continuing, to any Eligible Assignee or (iii) an assignment of all or a portion of the Loans pursuant to Section 10.07(l); **provided, that, (x) the Borrower may withhold its consent (in its sole discretion) to any assignment of any Loan and/or Commitment to any Person that is (A) not a Disqualified Institution but is known by it to be an Affiliate of a Disqualified Institution, regardless of whether any such Person is identifiable as an Affiliate of a Disqualified Institution on the basis of such Affiliate's name (other than any Company Competitor Debt Fund Affiliate (unless such Company Competitor Debt Fund Affiliate is separately a Primary Disqualified Institution)) and/or (B) known by it to be a "loan to own" investor and/or an investor primarily in distressed credits or opportunistic or special situations or any Affiliate of any such investor** and (y) other than with respect to any proposed assignment to any Person that is not an Eligible Assignee, the Borrower shall be deemed to have consented to any such assignment of Term Loans (and excluding for the avoidance of doubt, any assignment of Revolving Credit Commitments) unless it shall have objected thereto by written notice to the Administrative Agent within 15 Business Days after having received notice thereof.

As the lead-in notes, a borrower has a consent right to assignments, which is not to be unreasonably withheld. Although there is case law in the real estate markets as to reasonableness of consents, there is no similar well-

established case law in the leveraged loan markets. Accordingly, to avoid costly litigation as to whether consents are withheld for legitimate business reasons, sophisticated borrowers have negotiated consent rights that are noted in bold above. Inclusion of such language is not without risk. As reported by the Creditors Rights Coalition in 2023, the inclusion of distressed or loan-to-own investors raised issues in litigations for Serta Simmons and Byju's.¹³ As further noted by the Creditors Rights Coalition, one private equity sponsor used such provisions to prevent assignments of a portfolio company's debt to a well-known distressed investor.¹⁴ Notably, a group of lenders to such portfolio company recently signed a cooperation agreement ahead of such company's 2026 revolving credit facility maturity.¹⁵

Whether a market participant finds such consent rights troubling or welcoming depends on the perspective — such language impacts liquidity in the lending markets and the ability to exit trades; depending on the drafting of the loan agreement, and whether provisions can apply retroactively, trades may be in limbo or cause a potential lender to be forced to trade out at a loss; from a borrower's and its private equity sponsor's perspective, such consent rights enhance a borrower's Know Thy Lender protections.

Addressing Drawbacks in 'Net Short Lender' Provisions

"Net short lender" provisions became commonplace in the market following the bankruptcy filing by Windstream Holdings Inc. in 2019. Windstream filed for bankruptcy following an adverse court decision in favor of bondholder Aurelius Capital Management. As reported by Bloomberg, Aurelius is believed to have purchased derivatives insuring against a Windstream default.¹⁶ Thereafter, borrowers and their private equity sponsors started including provisions that would protect borrowers from creditors that would benefit from pushing the borrower into distress over defaults. By July 2024, net short lender provisions appeared in 75% of high-yield bond offerings in the U.S.¹⁷

Although various formulations of net short lender provisions have appeared in the market, the general result has been disenfranchisement of net short lenders (other than with respect to customary "sacred rights" that by their terms more adversely impact such net short lenders than the other affected lenders), limitations on access to confidential borrower information and prohibitions on assignments to such net short lenders.¹⁸ As discussed by numerous practitioners and commentators, the earliest net short lender provisions contained numerous drawbacks, including failures to provide a framework for defining what constitutes a net short position and applying such provisions to an unidentifiable group of creditors.¹⁹ Borrowers and their private equity sponsors have addressed such drawbacks, as evidenced in recent transactions.

Example language from a recent transaction follows: ²⁰

"Net Short Lender" means, at any date of determination, each Lender that has a Net Short Position as of such date; provided that Unrestricted Lenders shall not be Net Short Lenders.

"Net Short Position" means, with respect to a Lender (other than an Unrestricted Lender), as of a date of determination, the net positive position, if any, held by such Lender that is remaining after deducting any long position that the Lender holds (i.e., a position (whether as an investor, lender or holder of Loans, debt obligations and/or Derivative Instruments) where the Lender is exposed to the credit risk of Deliverable Obligations of the Loan Parties) from any short positions (i.e., a position as described above, but where the Lender is instead protected from the credit risk described above).

For purposes of determining whether a Lender (other than an Unrestricted Lender) has a Net Short Position on any date of determination:

(iii) Derivative Instruments shall be counted at the notional amount (in Dollars) of such Derivative Instrument; provided that, subject to clause (v) below, the notional amount of Derivative Instruments referencing an index that includes any of the Loan Parties or any bond or loan obligation issued or guaranteed by any Loan Party shall be determined in proportionate amount and by reference to the percentage weighting of the component which references any Loan Party or any bond or loan obligation issued or guaranteed by any Loan Party that would be a "Deliverable Obligation" or

an "Obligation" (as defined in the ISDA CDS Definitions) of the Loan Parties;

(iv) notional amounts of Derivative Instruments in other currencies shall be converted to the Dollar equivalent thereof by such Lender in accordance with the terms of such Derivative Instruments, as applicable; provided that if not otherwise provided in such Derivative Instrument, such conversion shall be made in a commercially reasonable manner consistent with generally accepted financial practices and based on the prevailing conversion rate determined (on a mid-market basis) by such Lender, acting in a commercially reasonable manner, on the date of determination;

(v) Derivative Instruments that are documented using either the 2014 ISDA Credit Derivatives Definitions or the 2003 ISDA Credit Derivatives Definitions (or any successor definitions thereof, collectively, the "ISDA CDS Definitions") shall be deemed to create a short position with respect to the Loans if such Lender is a protection buyer or the equivalent thereof for such Derivative Instrument and (A) the Loans are a "Reference Obligation" under the terms of such derivative transaction (whether specified by name in the related documentation, included as a "Standard Reference Obligation" on the most recent list published by Markit, if "Standard Reference Obligation" is specified as applicable in the relevant documentation or in any other manner) or (B) the Loans would be a "Deliverable Obligation" or an "Obligation" (as defined in the ISDA CDS Definitions) of the Loan Parties under the terms of such derivative transaction;

(vi) credit derivative transactions or other Derivative Instruments not documented using the ISDA CDS Definitions shall be counted for purposes of the Net Short Position determination if, with respect to the Loans, such transactions are functionally equivalent to a transaction that offers such Lender protection in respect of the Loans; and

(vii) Derivative Instruments in respect of an index that includes any of the Loan Parties or any instrument issued or guaranteed by any of the Loan Parties shall not be deemed to create a short position, so long as (A) such index is not created, designed, administered or requested by such Lender and (B) the Loan Parties, and any Deliverable Obligation of the Loan Parties, collectively, shall represent less than 5.0% of the components of such index.

"Net Short Representation" means, with respect to any Lender (other than an Unrestricted Lender) at any time, a representation and warranty (including any deemed representation and warranty, as the case may be) from such Lender to the Borrowers that it is not (x) a Net Short Lender at such time or (y) knowingly and intentionally acting in concert with any of its Affiliates for the express purpose of creating (and in fact creating) the same economic effect with respect to the Loan Parties as though such Lender were a Net Short Lender at such time.

In addition to customary prohibitions on assignments to such net short lenders and prohibiting disclosures of confidential information to such net short lenders:

- The remedies section explicitly requires that any lender requesting the agent to deliver a notice of default, event of default or acceleration accompany the request by a written net short representation or be deemed to represent that it is a net short lender (except during the pendency of a bankruptcy or insolvency proceeding, when no such net short representation is necessary). ²¹
- In connection with the delivery of any written consent to any amendment, waiver or consent under the credit agreement and related loan documents, a lender is required to deliver a net short representation (or be deemed to have delivered a net short representation). ²²
- Net short lenders are disenfranchised from all voting matters. ²³

Once again, whether a market participant finds such consent rights troubling or welcoming depends on the perspective. The inclusion of such provisions impacts liquidity in the leveraged lending markets, which may increase the costs of borrowing; however, borrowers and their private equity sponsors may be willing to incur such additional costs to exclude creditors that are actively betting against the borrower by use of credit default swaps and other derivative instruments. Based on the prevalence of net short lender provisions, it appears that borrowers and their private equity sponsors have embraced such risk and have drafted precise provisions to determine what constitutes a net short

provision and to cause such net short lenders to self-identify, thereby enhancing the borrower's Know Thy Lender protections.

Looking Ahead

Leveraged lending markets continue to evolve. Market participants ostensibly need to balance a borrower's requests for Know Thy Lender protections and a lender's need for flexibility in managing its exposure to a borrower or an industry. Whether voting caps and expanded consent rights become "market" or carefully drafted net short lender provisions get bypassed by savvy lenders remains to be seen. Such provisions will be carefully monitored by industry practitioners as markets rebound and deal flow accelerates into 2026.

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23. *Id.* ↵

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