Delayed Compensation

What is delayed compensation?
Delayed compensation¹ is a pricing adjustment payable by the parties to a secondary loan trade that closes late, intended to assure that neither party derives an economic advantage from the delay.

How late does a trade have to close for delayed compensation to be payable?
For distressed trades, more than 20 business days after the trade date (T+20); for par/near-par trades, more than seven business days.

Who pays delayed compensation?
Both parties. In general², Buyer pays Seller LIBOR interest for the period of delay, calculated on the purchase price Seller would have received had the trade closed on time (this portion of delayed compensation is referred to as “cost of carry”). Seller generally pays Buyer the amount of interest and accruing fees attributable to the debt for the period of delay that Buyer would have earned if the trade had closed on time.

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¹ “Delayed Compensation” is defined in the Standard Terms and Conditions for, respectively, Distressed and Par/Near-Par Trade Confirmations published by the Loan Syndications and Trading Association (“LSTA”). A comparable definition, called “Delayed Settlement Compensation”, is used under the Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims) published by the Loan Market Association (“LMA”). For purposes of simplicity, these FAQs discuss only the LSTA’s “delayed compensation” rules.

² The mechanics, definitions and exceptions to the delayed compensation rules are set forth in the LSTA Standard Terms and Conditions for Par/Near Par (“Par STC”) and LSTA Standard Terms and Conditions for Distressed Trade Confirmations (“Distressed STC”). See Par STC, §6; see also Distressed STC, §6.

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Why do I have to pay delayed compensation if the other party is the one that delayed?
The rules operate without regard to fault. The idea is to put the parties in the same place they would be had the trade closed on time.

If Seller credits accrued interest to Buyer at closing, once the Borrower makes the next scheduled interest payment to Buyer after closing, won’t Buyer have received double the interest?
Only temporarily. Although the typical distressed “settles without accrued interest” trade requires Seller to “front” to Buyer all interest accruing during the delay period after T+20 until closing, if and when Borrower makes its regularly scheduled interest payment at the end of the current interest period, Buyer returns the favor by remitting to Seller (among other amounts), to the extent actually received by Buyer from Borrower, an amount equal to the interest Seller fronted.

Is delayed compensation calculated differently in the “trades flat” situation?
Loans trade “flat” (i.e., without any cost to Buyer for interest that has already accrued on the loans) when interest has stopped accruing on the loans, usually due to the commencement of a Chapter 11 or when any period for Borrower to cure a default under the applicable loan agreement has expired. Because of how unlikely it generally is that accrued interest will ever be paid on a loan that trades flat, and because Buyer is already deemed to be entitled to receive without additional cost any such interest that is ultimately paid on the loans, no delayed compensation is required to be paid to Buyer on a “trades flat” sale.

What is the “25% Rule” for delayed compensation, and when does it apply?
The “cost of carry” component of delayed compensation is calculated based on the purchase price that would have been payable if the transaction closed no later than scheduled (i.e., by T+20). This calculation can be skewed, however, when the outstanding principal at T+20 is significantly reduced prior to the closing date, lowering the purchase price ultimately payable and, theoretically, the amount of “cost of carry” Seller should be entitled to for the payment of such purchase price being delayed.

To account for this, the delayed compensation rules provide that if the principal amount being transferred between T+20 and the actual closing date ultimately changes by 25% or more, cost of carry is calculated instead based upon the average outstanding principal amount of loans for each day during the delay period.

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3 See Par STC, §5; see also Distressed STC, §5.

4 See Par STC, §6; see also Distressed STC, §6.
How does delayed compensation work in a par/near-par trade?
Fundamentally, delayed compensation in par/near-par trades differs from delayed compensation in distressed trades in that it contemplates a single payment by Seller to Buyer, roughly equal to the amount by which the benefit of contract interest under the loan agreement exceeds LIBOR. Under the existing rules, there are three different ways to calculate delayed compensation for a par/near-par trade depending upon the loan characterization. Specifically, in the case of LIBOR loans, this requires Seller to pay Buyer the applicable margin on the loans; in the case of non-LIBOR based loans, Seller pays Buyer the amount by which the all-in-rate exceeds LIBOR. A proposed revision to these rules is currently pending, however, to have par/near-par trades adopt the same rules as those applicable to distressed trades.

What delayed compensation is payable in respect of “payment-in-kind”, or “PIK”, interest?
None. PIK interest that has not been capitalized as of the trade date does not increase the principal amount of the loans being sold for purposes of calculating delayed compensation, regardless of whether such interest is capitalized, in whole or in part, prior to closing. Buyer receives this PIK interest for free, just as it receives accrued interest for free in a “trades flat” situation.

Does delayed compensation apply on private equity trades?
No, the LSTA rules apply only to secondary loan trading, not to trading private equity, so delayed compensation would not apply to such trades unless the parties mutually agreed to the contrary. They rarely do so on such trades, even though Seller’s cost of carry on a delayed private equity trade is real.

If a trade is terminated under the new distressed Buy-In Sell-Out (“BISO”) rules, is delayed compensation still payable on the terminated trade in calculating how much the terminating party is owed by (or owes) its counterparty on the terminating party’s cover trade?
Yes. Under distressed BISO rules recently enacted by the LSTA, a performing party on a distressed trade that terminates a trade in accordance with the rules because of undue delay by its counterparty is required to enter into a “cover trade” for the termination to be effective; the difference between the price on the cover trade and the original purchase price is required to be paid by the appropriate party to preserve the economics of the original trade. The rules expressly provide that delayed compensation is still calculated on the original purchase price for such purpose, though it only runs until the earlier of the closing of the cover trade or T+20 on such trade – at which point, presumably, delayed compensation on the cover trade begins to kick in.

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6 See Par STC, §16; see also Distressed STC, §16.

7 See Par STC, §§17(b),18(b); see also Distressed STC, §§17(b),18(b).
Can parties suspend the application of delayed compensation by mutual agreement?
Yes. Such an agreement can be reached by the parties at any time prior to closing. Since delayed compensation applies by default unless the parties mutually agree to opt out of it\(^8\), however, a party that intends for delayed compensation not to apply would do well to raise this issue with its counterparty on the trade date.

\(^8\) By contrast, the LMA instead requires an affirmative election to have cost of carry apply to the trade. See Condition 10.2 of the LMA Standard Terms and Conditions for Par and Distressed Trade Transactions.