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Riskless Principal

What is a riskless principal, and how can a party to a distressed debt trade be treated as one?

In the secondary loan market parlance, a riskless principal is a party that purchases loans for its own account, subject to its ability to resell the loans, generally contemporaneously.¹

When does a buyer qualify as a riskless principal?

LSTA² rules require a party seeking to qualify as a riskless principal to disclose this fact to its counterparty. The intention to act as a riskless principal should be specifically referenced in a trade ticket or internal record for the trade³, and included in the parties' confirmation letter.

Is a riskless principal required to disclose the identity of the party to which it is reselling the loans it is purchasing?

No. A riskless principal is under no obligation to disclose to its seller the identity of its purchaser. In theory, a riskless principal has the ability to substitute end-buyers prior to settlement.

¹ See LSTA Standard Terms and Conditions for Distressed Trade Confirmations ("Distressed STC"), §22.

² Loan Syndications and Trading Association.

³ See NY Gen. Oblig. Law §5-701b.(2)(b), (3)(b).

Does a seller of distressed loans have recourse against a riskless principal that fails to complete a transaction?

Generally not, assuming that the riskless principal's failure resulted from its inability to close with its end-buyer, provided that the riskless principal negotiated with its seller in good faith as required under New York law⁴.

Where a sale of loans to a riskless principal fails to close, does Seller have recourse against the riskless principal's end-buyer?

No, unless the end-buyer expressly agrees to the contrary (a) directly with the seller, or (b) in the end-buyer's agreement with the riskless principle, provided that the agreement makes the seller a third-party beneficiary of the riskless principal's rights thereunder.

Are the representations and warranties a buyer of distressed loans received on a riskless principal trade the same as in an ordinary principal trade, and if not, why should the buyer agree to them?

Unlike sellers in ordinary principal trades of distressed loans, riskless principals are generally required to make only so-called "flip", or pass-through, representations and warranties to their end-buyers. Flip representations differ from usual, or "flat", representations and warranties in that they do not contain absolute seller assurances as to title, outstanding principal and commitment amounts, and other issues relating to the underlying loans.

This disparity in buyer recourse is moderated in part by the fact that the end-buyer not only knows the identity of the riskless principal's upstream seller, but has direct recourse against that party, since all upstream seller representations and warranties under distressed purchase and sale agreements are generally reassigned to end-buyers.⁵ As a result, the buyer's willingness to agree to a riskless principal arrangement can depend in part upon whether it is comfortable relying mainly upon its recourse against its upstream sellers, not its riskless principal counterparty.

⁴ See *Dalton v. Educational Testing Service*, 87 N.Y.2d 384, 639 N.Y.S.2d 977, 663 N.E.2d 289 (1995) (implicit in all contracts is a covenant of good faith and fair dealing in the course of contract performance. This duty of good faith and fair dealing "includes a promise not to act arbitrarily or irrationally" when the contract contemplates an exercise of discretion).

⁵ See LSTA Standard Terms and Conditions for Purchase and Sale Agreements for Distressed Trades ("PSA STC"), §2(b). Buyer acquires the Transferred Rights, which include, among other things, "...all of Seller's right, title and interest in, to or under the Loan and the Commitments and... the Predecessor Transfer Agreements..."

How does a riskless principal trade differ from an agency trade?

Unlike a riskless principal trade, in an agency⁶ trade, a broker-dealer intermediary generally acts as agent for the end-buyer/principal. The end-buyer assumes the agent's responsibility in respect of the trade (for the agent's obligations to be so limited, its status as agent and the identity of the end-buyer/principal generally need to be disclosed no later than the trade date⁷). The seller, end-buyer and agent will all generally sign a single confirmation letter with respect to the trade and the purchase and sale agreements and assignments executed at closing will generally run directly from the seller to the end-buyer.

Finally, unlike in a riskless principal trade, it is possible in an agency trade to have the purchase price for the transaction to flow directly between the seller and the end-buyer, with a separate "spread" or commission paid by the buyer to the dealer/agent.

Do the new distressed Buy-In Sell-Out ("BISO")⁸ rules apply to riskless principal trades?

No, the BISO rules expressly state that they do not apply to riskless principal trades.

⁶ See *Rennerty-Diana & Co., Inc. v. Costarino*, 128 A.D.2d 691, 513 N.Y.S.2d 190 (1987). This discussion assumes that the agent is acting on behalf of a fully-disclosed principal. Non-disclosure or only partial disclosure of the agency may result in the agent incurring principal liability for the trade.

⁷ See Distressed STC, §22.

⁸ See our answers to Frequently Asked Questions regarding Distressed BISO Rules, *available at* <http://www.kieselaw.com/claims-trading-faq/distressed-biso-rules>.