Participation Trophies: Documenting and Negotiating Loan Participations

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By **Ryan B. Leverone**
Special Counsel | Corporate Finance

By **Angie Batterson**
Partner | Fund Finance

As the secondaries market continues to grow and increase in complexity, we have noticed an uptick in interest among our clients in selling (and buying) loan participations. Participation arrangements can be a powerful tool for institutions on either side of the transaction – sellers can free up capital on their balance sheet, pare back funding obligations and reduce exposure to certain borrowers or industries, and buyers can get the economic benefit of a loan without having to manage a direct relationship with the borrower or comply with (typically more stringent) restrictions and consent requirements for direct assignments. Plus, while the transaction is undoubtedly complex, both parties can leverage the Loan Syndications and Trading Association's form documentation to keep attention focused on those provisions most important to their institution and the specific transaction. Done right, a bespoke participation arrangement lets everyone leave the field a winner (trophies optional).

Below we discuss broadly the participation structure and its benefits, typical principal documentation and some key considerations and commonly-negotiated provisions.

Participation Structure and Its Benefits

For the uninitiated, a participation is best understood in contrast with an assignment. Both are mechanisms by which a lender of record under a loan agreement (*i.e.*, the entity that is actually party to the contract as a lender) can transfer all or part of its interest in a funded or unfunded loan to a third party. However, unlike with an assignment (where the assignee steps fully into the shoes of the assignor as lender of record, and assumes direct contractual privity with the borrower and legal and beneficial ownership of the loan), the seller of a participation interest retains title to the loan and direct contractual privity with the borrower (*i.e.*, the participant does not become a lender of record under the loan agreement) along with certain rights and obligations, and the buyer of a participation interest assumes the economic benefits and risks. The contractual relationship for a participation is just between the seller and buyer – the borrower is not typically involved, and indeed is often not even aware of the transaction.

Among the benefits to sellers of loan participations, perhaps the most obvious is the cash received from the buyer upon settlement. Loan participations in the non-distressed secondaries space are often purchased for prices at or near par (*i.e.*, 100% of the principal amount of the debt participated), and that cash lands immediately on the seller's balance sheet. For unfunded loans, because the participation agreement obligates the participant to fund (or reimburse, depending on timing) future draws through the seller, a seller also benefits by shifting much of the responsibility to fund future draws to the participant (noting, of course, that this introduces new credit risk with respect to the buyer). In addition, regulated lenders are not typically required to hold capital against participated loans. Sellers can also realize value by retaining some of the economics of the loan they're selling a participation interest in. We see many participations where sellers retain some or all upfront fees paid by the borrower in respect of the loan, and a number where the buyer takes a haircut on the interest payments that are passed through to them, with the seller retaining the difference (noting that, if a seller is not passing along all or substantially all of the rights and obligations under the loan, the parties should carefully consider with counsel whether the sale would still be considered a true participation under New York law – if it wouldn't, buyer may be at risk of being considered a mere contractual counterparty of seller subject to seller's credit risk). Taken together, sellers can use participation arrangements to put cash on their balance sheets, reduce exposure to certain borrowers or industries and decrease regulatory capital obligations in compliance with internal or external requirements.

On the buyer's side of the transaction, buyers benefit from being able to realize some or all of the economic benefits of a loan without incurring origination expenses, the bulk of ongoing administration expenses or the legal expense associated with preparing the underlying loan documentation (subject, of course, to indemnities, etc., that can flow through to a participant, *e.g.*, agent expenses). From a credit perspective, depending on buyer's internal comfort level, a buyer can draft to varying degrees behind the seller's credit analysis and diligence of the borrower. In addition, since participants are typically not disclosed to a borrower, a buyer can generally keep its status as participant confidential.

Buyers and sellers alike benefit from not needing to seek consents and pay assignment or other fees that might be required in the case of a direct assignment.

Typical Principal Documentation

Sellers and their counsel typically hold the pen when documenting participation arrangements. While drafting parties can and do use their own forms, it often makes sense to leverage the Loan Syndication and Trading Association's (LSTA) standard form participation agreement for par/near-par (*i.e.*, non-distressed) trades as a starting point – even for bespoke, heavily-negotiated participations. The LSTA's form participation agreement was developed to facilitate efficient documentation of transactions in the high-volume secondary market (where participations are often used as a backup settlement option for debt trades that can't settle by assignment), and accordingly generally tracks market-standard terms and mechanics for participation arrangements. The LSTA form splits the participation agreement into two documents: (i) a longer set of standard terms and conditions (often referred to as STCs, and available **here** for LSTA members), which contains a baseline set of market-standard provisions, and (ii) a relatively short form agreement setting forth the transaction-specific terms of the participation (often referred to as the TSTs, and available **here** for LSTA members), which incorporates the STCs by reference and lets parties toggle on or off (often via checkbox), or otherwise supplement or modify, the various provisions of the STCs. The LSTA's bifurcated documentation pulls all the transaction-specific information, business terms and frequently negotiated provisions into a more manageable document.

Of course, there are a number of points in the LSTA forms that counsel will typically want to smooth out when using them outside of the more commoditized secondary loan trading market (*e.g.*, the need for trade confirmations and funding memoranda, delayed compensation, etc.). Nevertheless, starting with LSTA forms helps both buyer and seller cut down on legal expense, and focuses attention on the terms and provisions that are of particular importance to the parties and the specific deal. These efficiencies can also facilitate innovation.

Key Considerations and Commonly-Negotiated Provisions

Bespoke participation agreements are just that – bespoke. Cadwalader has helped clients tailor participation agreements to address a wide variety of institutional and business issues. There are a number of points, however, that come up with some frequency – below is a handful of examples.

Elevation. Buyer's rights to request "elevation" of its participation (*i.e.*, to seek to become a direct lender under the loan agreement) is often the subject of negotiation. Under the STCs, a buyer can always elevate if seller goes into bankruptcy. Otherwise, it's up to the parties – in some transactions buyers are free to elevate at any time. In others, elevations triggers are heavily tailored, and can include conditions tied to seller's credit rating, the amount of seller's loans or commitments under the facility, disputes over collateral value (particularly for participations in NAV loans) or the occurrence of certain events (or failures by seller to take certain actions) under the loan documents.

Voting. The voting provisions in the participation agreement govern whether, when and to what extent, the buyer can direct seller's votes as a lender under the loan documents. Participation provisions in loan agreements will sometimes limit a seller's ability to grant voting control to a participant beyond the typical suite of "sacred" provisions (*e.g.*, facility size, interest rates, payment dates, term, etc.). Otherwise, the parties can and do tailor the allocation of control to their liking – from no buyer voting rights at all to full buyer voting rights and everything in between. Buyers will often push for control over at least the "sacred" provisions in the loan documents. Sometimes buyers request decision-making power over waivers of certain events of default, facility subordination or other provisions important to the buyer's credit analysis or institutional concerns. If the underlying loan agreement does include limitations on the seller's ability to grant voting control, parties will typically clarify in the participation agreement that any voting rights allocated to buyer are allocated only to the extent it would not violate the loan agreement.

Sub-participations. One standard provision of the STCs we frequently see negotiated is the requirement that seller consent to a requested sub-participation by buyer "not be unreasonably withheld or delayed." Often, sellers will request that that language be deleted. Buyers, in turn, will request some exceptions (*e.g.*, permitting sub-participations to affiliates, if seller's hold on the facility drops below some specified amount, etc.).

Loan agreement diligence. Buyers and sellers should take care to consider the terms of the underlying loan documentation when documenting participation arrangements. Loan agreements in the secondaries market do not always include the detailed assignment and participation provisions lenders might expect in a loan agreement drafted with an eye towards syndication – indeed, it's not infrequent that we see loan agreements that are silent on the subject. Sometimes there will be credit agreement provisions that necessitate representations from buyer or seller (*e.g.*, a representation that buyer is not an affiliate of the borrower, not on a disqualified institution list or not otherwise an ineligible buyer) or explicitly require that seller maintain a participant register for tax purposes. While uncommon, credit agreements occasionally include borrower or other consent requirements for lender participations (and often the consequence for failing to obtain that consent is that the transaction is void). Additional complexities are introduced when participating in a bilateral loan – in the event a buyer wants to elevate its participation interest, significant revisions to the loan documents may be required to accommodate a multi-lender structure. Often specifically tailored provisions are required in the participation agreement to address a given loan agreement.

The above is just a sampling of bespoke provisions Cadwalader has handled in the market – everything from dispute mechanics, rights of first refusal/offer, elevation facilitation, heightened standards of care, tag alongs, etc., have crossed our desks. Even using the LSTA forms to create aircraft carrier-esque master participation agreements that function as platforms for participating multiple loans between institutions (rather than just one loan participation per participation agreement).

Conclusion

Participation arrangements, particularly those that leverage LSTA documentation, offer buyers and sellers quite a bit of deal-making flexibility and opportunity, and the above is just an overview. It is important to seek guidance from counsel and address the particular nuances of the deal at hand. Cadwalader, of course, is happy to assist should your institution choose to participate in a participation.

Capital Idea? Risk-Based Capital, Capital Relief Trades and the Proposed Basel III Endgame Capital Rules

August 4, 2023

By **Jed Miller**
Partner | Financial Services

By **Daniel Meade**
Partner | Financial Services

By **Ivan Loncar**
Partner | Financial Services

On July 27, 2023, the U.S. federal prudential bank regulators (the **Federal Deposit Insurance Corporation**, the **Federal Reserve Board** ("FRB") and the **Office of the Comptroller of the Currency**) proposed new capital requirements for large banking organizations. The FRB also proposed to make certain adjustments to the G-SIB surcharge. Over the last week, we've received a number of inquiries from banks and buy-side clients about this proposal – in particular, about its effect on banks' risk-based capital, including for fund finance transactions, and capital optimization strategies, such as capital relief trades and synthetic securitizations. Here are some key takeaways in that regard:

- **Overview**. The proposal would effectively replace the internal models-based "advanced" approach for determining risk-based capital with a new framework designed to be simpler and more consistent with the existing standardized approach framework. The proposed new framework is referred to as the "expanded risk-based approach."
- **Scope**. The proposal only applies to "large banking organizations" – *i.e.*, banking organizations with total assets of $100 billion or more and their subsidiary depository institutions.
- **Dual Stack Calculation Requirement**. The replacement of the advanced approach with the proposed expanded risk-based approach would not eliminate the requirement for large banking organizations to calculate capital twice. Large banking organizations would still need to calculate their capital requirements under both the standardized approach and the proposed expanded risk-based approach, and use whichever method yields a higher capital requirement. Because large banking organizations include banks that were not previously subject to the advanced approach, the proposal would expand the number of institutions subject to this type of a "dual-stack" capital calculation.
- **Timing**. The proposal is expected to take effect over a three-year phase-in period, beginning in mid-2025.
- **Risk-Weights**. Risk-weights for most exposure types would be determined differently under the proposal. For example, under existing U.S. capital regulations, performing "corporate exposures" are generally assigned a 100% risk-weight. Under the proposal, corporate exposures to "investment grade" companies that have publicly traded securities outstanding (or that are controlled by companies that have publicly traded securities outstanding) may be assigned a 65% risk-weight. Other corporate exposures would be risk-weighted differently: qualifying central counterparties would receive a 2-4% risk-weight, project finance exposures would receive a 130% risk-weight, subordinate debt and covered debt instruments would (with certain exceptions) receive a 150% risk-weight, and all other corporate exposures – including those that finance income-producing assets or projects that engage in non-real estate activities where the borrower has no independent ability to repay the loan – would receive a 100% risk-weight. Ultimately, whether any particular exposure's risk-weight would change under the proposal is a facts-and-circumstances determination. However, we note that the risk-weights for some corporate exposures, such as most capital call loans, are unlikely to change under the proposal (*i.e.*, such exposures would continue to receive a 100% risk-weight).
- **Credit Conversion Factors**. Credit conversion factors ("CCFs") – which can reduce the risk-based capital for unfunded loan commitments and other off-balance sheet items – would also change. Under the existing capital framework, unconditionally cancellable commitments are assigned a 0% CCF, commitments of less than one year that are not unconditionally cancellable are assigned a 20% CCF, and commitments of one year or more that are not

unconditionally cancellable are assigned a 50% CCF. Under the proposal, unconditionally cancellable commitments would be assigned a 20% CCF, and all commitments that are not unconditionally cancellable would be assigned a 40% CCF. These changes are particularly relevant for banks with large portfolios of revolving corporate loan facilities and revolving capital call (subscription finance) loan facilities: uncommitted facilities, which currently receive a 0% CCF, would be assigned an increased CCF of 10% under the proposal, whereas committed facilities, which currently receive a 20% or 50% CCF (depending on the duration of the commitment), would be assigned a 40% CCF under the proposal (whether this is an improvement from the current capital treatment will depend on the duration of the commitment).

- **Operational Criteria for Synthetic Securitizations**. The proposal would add three new operational criteria for synthetic securitizations; any tranched capital relief trade that utilizes credit default swaps, financial guarantees or credit-linked notes would need to satisfy these additional operational criteria. The first of these new criteria would generally bar early amortization provisions in transactions where the synthetically securitized reference exposures are comprised of revolving assets. The second would prohibit synthetic securitizations from containing synthetic excess spread provisions. And the third would require a minimum payment threshold that is consistent with standard market practice.
- **Securitization Standardized Approach**. The proposal sets out a new formula for risk-weighting securitization tranches – the Securitization Standardized Approach ("SEC-SA"). The SEC-SA is substantively similar to the SSFA (*i.e.*, the formula used by standardized approach banks under the existing capital rules for assigning risk-weights to securitization exposures), with a few noteworthy changes, including: supervisory parameter p has increased from 0.5 to 1.0, the supervisory risk-weight floor for senior securitization exposures has been reduced from 20% to 15%, and variable Kg – which represents the weighed-average total capital of the securitized exposures – must take into account the risk-weight attributable to collateral held by SPV-issued credit-linked note structures. Based on our back-of-the-envelope calculations, the SEC-SA would require thicker tranche sizes for traditional and synthetic securitization structures to achieve the same RWA benefits as are currently afforded under the SSFA.
- **Restructuring**. Under the existing capital rules, the effective notional amount of an eligible credit derivative is reduced by 40% if the credit derivative does not contain restructuring as a credit event. Under the proposal, this requirement would not apply if both (i) the terms of the reference loan allow the maturity, principal, coupon, currency or seniority status to be amended outside of receivership, insolvency, liquidation or similar proceeding only by unanimous consent of all parties, and (ii) the bank has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the reference loan is subject to the U.S. Bankruptcy Code or a similar domestic or foreign insolvency regime.

If you have any questions about how this proposal affects your bank's regulatory capital or your capital relief trades, please don't hesitate to reach out to Cadwalader's **Basel III Endgame Taskforce**.

(The authors wish to thank counsel Michael Ena and associate Nikita Cotton for their contributions to this article.)

Cadwalader Partners Write Private Funds CFO Article on Continuation Funds

August 4, 2023

Cadwalader partners Brian Foster, Samantha Hutchinson and Patrick Calves recently wrote a *Private Funds CFO* article on the use of hybrid fund finance solutions by continuation funds.

You can access their article, "Continuation Funds and the Hybrid Solution," **here**.

Cadwalader Contributes Chapter to ICLG's Alternative Investment Funds 2023 Guide

August 4, 2023

Cadwalader partners Wes Misson and Samantha Hutchinson contributed a chapter, “Fund Finance: Past, Present and Future,” to *The International Comparative Legal Guide – Alternative Investment Funds 2023.* The chapter examines the ascendency of the fund finance market to 2021, the state of play as the financial conditions tightened, and how the market is likely to develop going forward.

The chapter was previously published in *The International Comparative Legal Guide – Lending and Secured Finance 2023.*

The International Comparative Legal Guide – Alternative Investment Funds 2023 is now live on ICLG.com, and the Cadwalader chapter can be accessed **here**.

Mathan Navaratnam Named ‘Legal Rising Star’

August 4, 2023

Cadwalader Fund Finance partner Mathan Navaratnam has been selected as a “Legal Rising Star” by Private Equity International (PEI) Group’s *Private Funds CFO* as part of its list celebrating up-and-comers who are going above and beyond for their clients and those who will steer the future of the private funds industry.

Mathan’s profile in *Private Funds CFO* highlights his experience in leading some of the largest and most complex fund finance transactions in recent years. Mathan has also been recognized as a leading practitioner by Legal 500 UK and was named one of Law.com International’s 2022 “Private Equity Rising Stars” in the UK and Europe.

You can read Mathan's profile **here**.

Agenda Announced for FFA Asia-Pacific Symposium

August 4, 2023

The FFA has announced agenda details for the fifth annual Asia-Pacific Fund Finance Symposium on October 12 at the Four Seasons Hotel in Hong Kong.

The Asia-Pacific Fund Finance Symposium is the premier event for professionals in the fund finance industry, bringing together leading experts, industry pioneers, and key decision makers from across the Asia-Pacific region. With insightful panel discussions and unparalleled networking opportunities, this symposium is a must attend for anyone involved in fund finance.

Click **here** for more information and **here** to register.

Inaugural FFA NextGen Newsletter Published

August 4, 2023

The FFA has just published the first issue of the NextGen Quarterly Newsletter. The issue covers NextGen programs and activities from Q2 2023 and provides a list of upcoming events.

You can sign up for the newsletter **here**.

On the Move – Jeff Jaenicke

August 4, 2023

On the Move

Jeff Jaenicke has joined Mizuho Americas as Managing Director, Head of Private Equity LP Fund Financing within the Equity Division.

In this role, Jeff will lead a team responsible for the sales, structuring, trading, and front office risk management for Private Equity LP financing transactions, focused on "Fund of Fund" Managers within Asset Management and Private Equity Funds.

Jeff previously worked at Credit Suisse for 25 years where he was the Global Head of Fund Financing business. He will be based in New York, reporting to Sandeep Sureka, Head of Structured Equity Finance & Swaps/D1 Trading.

You can read more **here**.

On the Move – Dominic Goh

August 4, 2023

On the Move

Dominic Goh has joined SMBC as an Executive Director to lead NAV financing within the Fund Finance Solutions Department in the New York office.

Dom will focus on further growing the NAV financing product suite that seamlessly complements the team's existing business at SMBC, a market-leading provider of fund finance facilities for sponsors. Dom was most recently at Credit Suisse, and has over 16 years' experience working in NAV and secondaries transactions, structuring bespoke asset-backed term loans and revolving credit facilities.

Fund Finance Hiring

August 4, 2023

Fund Finance Hiring

Standard Chartered Bank is looking to hire an Associate Director, Fund Finance. The successful candidate will be responsible for maximizing customer profitability from Financial & Strategic Investors Group and Financial Institutions relationships, contributing to origination, structuring, and execution of Fund Finance transactions. The candidate will also maintain governance and oversight of the Global Fund Finance book. The candidate should have a comprehensive understanding of lending products, including subscription finance, financing, and capital markets product experience, strong analytical, quantitative and credit underwriting skills, and the ability to negotiate and interpret legal agreements.

Additional details are available **here**.