KEY POINTS

- Under English law, the loan participant assumes a 'double credit risk' on default by either or both of the borrower and the lender of record.
- The possible steps that may be taken by the investor to mitigate credit risk are all subject to potential difficulties.
- A well advised investor would negotiate certain contractual provisions ensuring efficient control and information sharing in respect of the underlying loan.

Feature

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The legal cost of loan participations post financial crisis

This article assesses some legal risks associated with gaining loan exposure through a participation arrangement post the financial crisis.

The reallocation and transfer of risk is at the core of modern economies. Credit institutions, funds and other investment vehicles, insurance companies and governments all use an ever expanding universe of financial instruments to transfer risk.

The credit risk of loans can be transferred through buying or selling protection under credit default swaps/total return swaps or through investing in Collateralised Loan Obligations, Commercial Mortgage-Backed Securities and other securitisation structures that repackage loans, as well as through arrangements when the original lender turns over amounts received by the borrower. This article will review some of the key legal risks in assuming credit exposure through a loan participation arrangement (while acknowledging that there are a large number of possible contingencies, prior knowledge and preparation for which would be prohibitively costly.[1])

For the sake of simplicity, the transferor/lender of record/seller of the risk in the participation will be referred to as 'lender of record' and the participant/transferee/buyer of risk will be the 'investor'.

TYPES OF PARTICIPATION

Under a 'funded participation', the investor pays the lender of record an upfront lump sum that is non-refundable. The purpose of this payment is to enable the lender of record to fund all or part of the loan. In consideration, the lender of record covenants that it will pay over to the investor interest and principal amounts which it has received from the borrower under the loan.

Under a 'risk participation' arrangement, the investor agrees to cover amounts that were due by the borrower under the credit agreement but remain unpaid; for that, the lender of record pays a fee to the investor (so the arrangement is akin to a guarantee). In each case, the investor has no direct contractual relationship with the borrower.

ISSUES

Legal nature of investor's interest; counterparty risk

English law-governed participations have been held by the Privy Council[2] to constitute limited recourse back-to-back funding arrangements which do not change the beneficial ownership of the underlying loan. Therefore, if the lender of record becomes insolvent, the investor simply has an unsecured claim and cannot claim any proprietary interest in or entitlement to the underlying loan. The investor assumes a 'double credit risk' on default by either or both of the borrower and the lender of record.

Recent events in the financial markets have caused the reassessment of counterparty risk. Participants in the secondary loan market have expressed a particular concern over the exposure of investors to lenders of record in cases of funded participation. The Loan Market Association ('LMA') has striven to make participants aware of possible steps to mitigate the credit risk in this context.[3]

For example, an investor may request the creation of a trust by the lender of record over the relevant loan, establishing a proprietary interest in the loan in favour of the investor as beneficiary under the trust. Upon the insolvency of the lender of record, its liquidator/administrator would be obliged to pass over to the investor any identifiable loan proceeds the liquidator/administrator receives.[4]

Another possibility is the creation of a security assignment over the lender of record's rights to receive payments under the loan documentation and over the account into which interest and capital payments received under the loan documentation are paid.[5]

Alternatively, the investor may request that the lender of record provides credit support on entering into the participation or upon the occurrence of a trigger event such as a ratings downgrade, similar in structure to the credit support requirements under ISDA documentation.[6]

Upon the occurrence of certain trigger events (such as rating downgrade or market disruption) the lender of record may also be required to transfer the loan to the investor, ie, to 'elevate' the loan.[7]

Alternatively, funded participations may be documented under New York law. As a matter of New York law and under the current LSTA[8] model, the investor will acquire a beneficial interest in the underlying loan such that receipts by the lender of record under the loan documentation should be ring-fenced upon the lender of record's insolvency.

Unfortunately, all of the options mentioned above have potential issues; for example:

- The declaration of trust may create withholding tax issues.
- A security assignment over the right to receive payments under the loan will only be an equitable assignment if it relates to part of the participation in the loan or if no notice of the assignment is given to the borrower; until notice is given, the investor will not have priority over competing claims asserted by third parties against the borrower.
- A security interest would have to be registered by the lender of record under s 860 of the Companies Act 2006 or reg 10 of the Overseas Companies (Execution of Documents and Registration of

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Charges) Regulations 2009 which may be a significant practical issue.

- In a credit support arrangement, interest/dividends on the collateral may be subject to withholding tax (depending upon the nature of the credit support and the identity/jurisdiction of the parties); the provision of security would be subject to insolvency hardening periods for preferences (six months) and transfers at an undervalue (two years).
- There is uncertainty over the way in which a New York law participation should be construed as a matter of English law.

CONTROL

The investor has to ensure that it can effectively direct the lender of record in the exercise of rights and discretions under the loan; therefore, the investor should have a right, firstly, to be informed before any discretions are exercised under the loan and, secondly, to direct the lender of record how to 'vote' in respect of the loan. The consequences of failure to comply with directions should be carefully considered. Instead of simply relying on a claim for damages for breach of contract, the investor would be advised to insist on a contractual provision such that unapproved changes in the underlying loan documentation would not be binding on the investor, thus: (i) putting a contractual limit on the coverage of unforeseen liabilities; and (ii) addressing the moral hazard that the actions of the lender of record may be influenced by its transfer of the economic risk of the loan.

Negotiations about control would become complicated where: (i) the participation is less than 100 per cent of the lender of record's exposure; or (ii) where the lender of record is concerned about acts inconsistent with its policies or which may affect adversely the relationship with its customer. In such circumstances, a possible compromise may be to agree that: (i) that the lender of record would consult with the investor and take its views and interests into account; or (ii) that the lender of record will deal with the loan in a way that it would have done had it not sub-participated the loan;[9] or (iii) to spell out all key areas where the investor must retain control (such as in default and acceleration situations, waivers and restructuring) leaving the lender of record free to exercise discretion in respect of other non-material provisions of the loan.

INFORMATION PROVISIONS; CONFIDENTIALITY, PRICE SENSITIVITY

To be able to monitor the underlying loan transaction, ideally the investor has to receive all notices, reports and any other information that the lender of record has obtained in relation to the loan documents. However, this information sharing exercise is potnetially subject to legal restrictions:

- The duty of banker's confidentiality would require the lender of record not to disclose the customers' affairs (except where required by law or regulation).[10] Most well-drafted loan agreements will narrow down this duty by the borrower expressly agreeing that a lender may disclose information to a prospective assignee, transferee or a sub-investor; (the scope of the specific permissions will have to be assessed by both parties).
- Participants in loan trading would also have to consider price sensitivity issues and market abuse rules. They will have to monitor their compliance with the applicable regime aiming to prevent market abuse and insider dealing, especially where the borrower has listed securities.[11] For example, information that the borrower is about to reschedule its loans or to request material amendments and waivers from its lenders may trigger market abuse considerations and insider dealing restrictions when such events are significant enough to affect the price of securities issued by the relevant borrower and the information is not yet publicly available.[12]

ASSIGNMENT

The investor may, at some stage of the transaction or when it pays defaulted amounts to the lender of record, want to receive an assignment of the underlying loan. The terms of the loan agreement must be assessed to determine whether the proposed assignment would be permitted: if it breaches non-assignment provisions, it would be ineffective as against the borrower who can refuse to deal with the investor and may continue to make payments direct to the lender of record. Even if assignment is permitted in principle, there may still be other factors (such as tax, relationship issues or the specific definition of 'lender' in the underlying loan agreement) that the investor must consider prior to 'buying' the loan.

CONCLUSION

There are a variety of reasons why parties enter participation agreements. The lender of record may wish to decrease its exposure to the borrower, to diversify its loan portfolio or to release regulatory capital; an investor may want to gain credit exposure to the performance of the borrower but to avoid direct exposure to a particular country, industry or corporate.

In assessing the cost of achieving such goals, a well-advised participant would strive to drill through the legal issues associated with risk transfers through participations. In turn, those issues are only one part of the risk analysis of a loan participation, other areas that would need careful consideration include the tax aspects of the arrangement, as well as its accounting and regulatory treatment. ■

1 See Benjamin Klein 'Transaction Cost Determinants of "Unfair" Contractual Arrangements', *The American Economic Review*, Vol 70, Issue 2 (May 1980), 356-362, at p 365.

2 *Lloyds TSB Bank v Clarke* [2002] UKPC 41.

3 See LMA's January 2010 paper.

4–7 Page 2, ibid, p 3, ibid, p 5, ibid, p 6, ibid.

8 The Loan Syndication and Trading Association.

9 This is the LMA approach, see eg, Cl 7.3 of LMA's form for Risk Participation (Par).

10 A principle expounded in *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

11 See Market Abuse Directive (2003/6 EC) and s 118 of the FSMA 2000.

12 See LMA papers published in April 2006 and August 2007.