

# CLIENT ALERT

## LMA Loan Participations - Grantor Insolvency Risk

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In today's distressed global financial markets, the emerging focus is once again on counterparty credit risk, as it was in the aftermath of the Lehman Brothers collapse a decade ago. The European secondary loan market uses a standard form "loan participation" to transfer borrower risk and the economics of a loan in the secondary market. Several forms of loan participations are published by the London-based Loan Market Association (the "LMA"). For those investors holding loan participations under the LMA Funded Participation, a particular topic of concern, in addition to the credit risk of the underlying borrower, is the credit risk of the lender selling the loan in the market. The seller is called the "grantor" of the participation.

### Grantor Insolvency and the LMA Participation Agreement

Under English law, the purchase price paid by the participant under an LMA participation agreement is characterized as a loan from the participant to the grantor to be repaid solely to the extent the borrower makes payments on the underlying loan. Consequently, the participation agreement creates a debtor/creditor relationship between the grantor and the participant. Under such an arrangement, the grantor is obligated to pay to the participant a *pro rata* amount equal to principal, interest, fees and other distributions received by lenders under the credit agreement.

Due to the structure of the LMA participation arrangement, (i) the participant is not a direct party to the credit agreement governing the underlying loan, (ii) the grantor does not transfer or assign rights or obligations under the credit documentation to the participant, and (iii) the participant has no proprietary interest in either the loan or the credit documentation. The participant therefore has a contractual nexus with the grantor only and has no direct rights against the underlying borrower. Accordingly, in the event of the insolvency of the grantor, the participant will, absent agreement to the contrary, merely have the right to claim as an unsecured creditor in the insolvency of the grantor for unpaid amounts due under the participation agreement. This structure is very different from the form of "true sale" participation agreements used in the U.S. market.

### FOUR WAYS OF PROTECTING AGAINST GRANTOR INSOLVENCY IN THE EUROPEAN MARKET

#### 1. Elevation of Participation

The LMA Participation Agreement provides both the grantor and the participant the option to "elevate" the participation which allows either party to convert the participant's interest in the participated loans to a direct "lender of record" interest (subject to the terms of the credit agreement). If grantor credit worthiness becomes a concern, the participant may elect to elevate the participated loan and become a direct lender under the credit agreement. However, restrictions in the credit agreement, adverse tax implications as well as regulatory concerns (some jurisdictions regulate direct lending activity and becoming a lender of record may require a banking licence) could mean that elevation is not a viable option.

#### 2. Declaration of Trust over Loans

This solution utilises a trust structure, whereby the grantor creates a trust over the loans and all related proceeds in favour of the participant. With a trust structure in place, the loan assets would fall outside the Grantor's insolvent estate and the administrator or liquidator would be obliged to pass all loan proceeds to the participant, as the beneficiary under the trust. However, there are some disadvantages with the trust structure. Firstly, it only works to the extent the trust assets are traceable within the assets of the grantor's estate. Where assets are co-mingled, it may not be possible to specifically identify the relevant loans and related proceeds. The creation of a trust over loan assets may also be restricted under the terms of the relevant credit agreement so the relevant assignment/transfer provisions must be carefully reviewed to ensure the creation of the trust is not prohibited or requires consent. Furthermore, analysis of the tax implications of the trust structure must be completed, since beneficial ownership (and therefore responsibility for tax liability) may have been transferred to the participant.

### **3. Granting Security over the Loans**

Another commonly used method for protecting against a grantor's insolvency is the creation of a security interest over the loan assets by the grantor in favour of the participant. The security interest may take various forms, but the most effective method is the grantor's assignment of the rights (i) to receive payments under the credit agreement and (ii) over the account into which the loan proceeds are paid, in favour of the participant. It is common for loan agreements to permit lenders to create security over their loan assets to secure obligations of that lender, but the loan documentation must be reviewed to ensure that it is permissible. Where such security assignments are restricted, an alternative option is to create a fixed charge over the grantor's rights to receive payments under the credit agreement, which would fall outside of the assignment/transfer provisions of the credit agreement, as it does not transfer title to the participant.

The main benefit of these arrangements is that they are unlikely to pass withholding tax liability onto the participant, as may be the case with the trust structure discussed above. However, the non-standard nature of these arrangements would require significant legal input and the documentation creating the security may also need formal registration at U.K.'s companies register, Companies House, adding additional administrative burden and cost to the arrangement.

### **4. True-Sale Participation**

In theory, a properly drafted true-sale participation agreement should provide a participant protection from a grantor's credit risk, since it grants in favour of the participant a beneficial or equitable ownership interest in the underlying loan, which should be free from attack by an insolvent grantor's creditors in the future. Not only would the loan assets subject to the participation not be included in the grantor's insolvency estate, but the participant may also elevate the loans into its own name even after the grantor has filed for insolvency. Conversely, elevation is not an option under the LMA form of participation after the grantor has become insolvent as the participation does not grant a proprietary interest in the loans or the underlying credit documentation to the participant. As a result, any post-insolvency elevation would ultimately have the effect of removing assets from the insolvent estate of the grantor and could potentially be challenged as a preference (as was the case in the Lehman bankruptcy). One solution used in the secondary loan trading market in Europe is to use a "U.S.-style" form of participation in order to achieve a true-sale, but this involves a lot of re-engineering of the standard form of participation published by The Loan Syndications and Trading Association, Inc. in the U.S., and it is not certain how its use would be interpreted by the courts in Europe. Also, the transfer of beneficial ownership in the loan assets created by a true-sale participation might be construed by a European court as a transfer of legal title (rather than a mere beneficial (economic) interest), and therefore the type of transfer

that requires the written consent of the borrower under the credit agreement. In addition, using the U.S. participation would have the adverse effect of shifting the tax liability for the transaction from the grantor to the participant.

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