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Client Alert

Terminating a Loan Participation

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Selling a "loan participation" is a common form of ownership transfer in the secondary loan market. What is being sold? The legal answer is that the seller (or "grantor") sells, and the participant buys a "beneficial interest" in the loan. Who owns the loan? The answer is in two parts: the grantor continues to hold legal title to the loan, but the economics of the loan are now owned by the participant.

This is a key advantage of a properly drafted participation agreement – if a participation is treated as a true sale, it allows the grantor to remove the participated loan from its balance sheet. This arrangement benefits the participant as well, by protecting its interest in the loan if the grantor becomes insolvent. The participant's beneficial interest in the loan does not become part of, and is treated as legally separate from, the insolvent grantor's bankruptcy estate.

This feature creates a bug, however. When a participant holding a beneficial interest in a revolving loan fails to honor its funding obligations under the participation agreement, the grantor may not simply "terminate" the participation, because it has (truly) sold a beneficial ownership interest in the loan to the participant.

As borrowers continue to draw down their revolving credit lines and grantors become increasingly concerned with participants' ability to fund those advances, it is worthwhile to review the remedies available to grantors in this situation.

1. Remedies against a defaulting participant under the Participation Agreement, without a Collateral Annex.

Because a true sale participation is structured as a sale of a beneficial ownership interest in the underlying loans and commitments to the participant, the grantor does not have the right to unilaterally terminate the participation, even if the participant defaults on its funding obligations.

If the participant fails to fund an advance required under the participation agreement, then the grantor, as lender of record under the relevant credit agreement, will remain obligated to fund the borrower, and the newly-funded loans will be deemed to be part of the participation. Under a properly drafted participation agreement, any delay in the participant's funding of the draw will likely entitle the grantor to (x) set-off all or any portion of the unpaid draw against the participant's right to receive future payments with respect to the participation, and (y) charge the participant interest from and including the time that the grantor funds the draw to but excluding the date the participant pays the funding advance to the grantor.

The grantor may have an indemnification claim against the participant for any damages that result from the participant's breach of its covenant to fund under the participation agreement, but the value of such an unsecured contractual claim against an insolvent counterparty may be limited.

The Loan Syndications and Trading Association, Inc. ("LSTA") has published several standard form participation agreements, but unlike derivative arrangements used for multiple transactions across various products and which are governed by a master agreement between a dealer and a counterparty, LSTA participation agreements are structured as "stand-alone" documents and do not include cross-default or netting provisions. The grantor typically will not have the right to set-off an unpaid draw against the participant's right to receive payments in respect of other participations that the participant may hold under the grantor.

2. Remedies against a defaulting participant under the Collateral Annex.

Incorporating an LSTA Collateral Annex into a participation agreement obligates the participant to deposit cash or securities into a collateral account as security for its future funding obligations under the participation agreement and, most importantly from the grantor's perspective, gives the grantor a security interest in the participation itself.

So, under a true sale participation the grantor sells a beneficial interest in the loan to the participant, and under the collateral annex the grantor takes back a security interest in the participation, as well as the collateral.

Under the collateral annex, if a participant's funding failure is not cured within two business days after receiving notice from grantor of such failure, an event of default is triggered and the grantor may exercise its rights as a secured party over all collateral, including the participation and any collateral held in the collateral account.

This allows the grantor to terminate the participation agreement and, acting in a commercially reasonable manner, attempt to sell the underlying loan into the market. A prompt, "bids wanted in competition"-type auction targeted to the grantor's existing loan market accounts would likely be considered a commercially reasonable sale process.

The grantor would apply the proceeds from the sale of the loans and commitments, together with any cash realized from the liquidation of the collateral account, against the amount owed by the participant to the grantor as a result of the participant's funding failure. To the extent that the total amount realized in respect of all collateral exceeds the amount owed to the grantor, the excess would be paid to the participant. If the grantor is not made whole by the application of the collateral proceeds, it would have a continuing claim against the participant for unrecovered damages. Such a claim could include interest as well as costs and expenses (including attorney fees) incurred by the grantor in auctioning the terminated participation and liquidating the collateral account.

As the volume of borrowing of existing revolving commitments increases, grantors should ensure that they have perfected their security interests in their participations by filing Uniform Commercial Code financing statements against their participants. Many collateral annexes permit grantors to demand more collateral if the financial condition of their counterparty deteriorates, so careful monitoring of participants' creditworthiness may allow grantors to place themselves in a more advantageous position before a funding failure occurs.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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