CLIENT ALERT

The Problem of "Debtor-Creditor" Language when Selling Loans by Participation

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Participation agreements, in the form promulgated by The Loan Syndications and Trading Association, Inc. (LSTA), are widely regarded as dependable vehicles for conveying loan ownership interests from a lender to a participant as "true sales" in the United States. But what if the underlying credit agreement describes the participation as a financing relationship between a lender, as debtor, and participant, as creditor? The answer is unclear as a legal matter, and the existence of such language should give market participants pause if encountered in the loan origination or secondary trading contexts.

On August 31, the LSTA issued a market advisory noting that it was concerned that certain new originations in the U.S. loan market describe participations as "debtor-creditor" relationships.[1][1] This is a significant deviation from the prescribed drafting framework under the LSTA's forms of credit agreement and model provisions, which generally permits lenders to "sell" loans by participation. The recent increased usage of this language in U.S. credit agreements led the LSTA to recommend that loan market participants carefully review the participation-related transfer provisions found in credit agreements and be aware that deviations from LSTA language could jeopardize sale accounting treatment. We agree with the LSTA's recommendations.

Under generally accepted accounting principles, one of the requirements for sale accounting treatment is a finding of "legal isolation" – *i.e.*, that a transfer of an asset would put the asset presumptively beyond the reach of the transferor and its creditors, even if the transferor becomes a debtor in bankruptcy or (if it is an insured depository institution) becomes subject to receivership or conservatorship. Underlying this legal isolation issue is whether an asset transfer would, under relevant state and federal law, be held to be a true sale *rather than* a disguised secured financing (with the seller as *de facto* borrower, the participant as its creditor and the purportedly sold asset serving as mere collateral). In the case of a transfer of a loan participation, this can be a complex legal question, requiring analysis of a variety of facts and circumstances surrounding a transaction against principles distilled from decades of true sale jurisprudence. Fortunately for market participants today, most routine participations of funded loans documented on LSTA standard participation agreements are not considered controversial and can be accounted as sales without an extensive (and costly) *de novo* legal review.

That, however, may not be true in the context of a credit agreement with atypical transferability terms – in particular, terms that provide that any participation thereunder is not a sale but rather is a financing between the lender and participant. Such a fact complicates analysis of a participation as a true sale, because when considering whether a true sale exists, relevant case law puts great weight on the parties' objective *intent* to execute a true sale. Would, for example, a bankruptcy court doubt that a lender (as transferor under a participation agreement) truly *intended* to *sell* its loan interests if the same lender had also agreed (as party to the credit agreement) that any participation creates a debtor-creditor relationship between the seller/lender and the participant? Possibly. Although not necessarily conclusive evidence, it is likely a bad fact weighing against a true sale conclusion. Therefore, any seller seeking sale accounting treatment, or buyer seeking to avoid entanglement in a seller's potential future insolvency proceeding, should be aware of the risk such debtor-creditor language poses.

Though true sale analyses are complex, the advice for lenders and participants in this context is straightforward:

- Absent a compelling justification, urge deal counsel, agents and arrangers to use LSTA model (or other true sale compliant) language in drafting participation transfer provisions for U.S. credit agreements.
- Prior to consummating secondary market trades that may settle by participation, carefully diligence loan documentation's transferability provisions for "debtor-creditor" participation language.
- If a credit agreement's language is problematic and sale by participation remains desired, consult with accounting and legal advisors to determine (1) whether such language introduces the need to obtain a new "true sale" legal opinion to satisfy the legal isolation condition for sale accounting treatment, and (2) if so, whether such an opinion could be obtained after full consideration of the "debtor-creditor" credit agreement language, the terms of the participation agreement and other material facts and circumstances pertaining to the transaction.

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[1] *"Participation Provisions in Credit Agreements Market Advisory"*, LSTA, August 31, 2021.

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