US and UK compared

Fundamental differences remain between the markets. But is it worth considering using a New York participation agreement in an English deal?

Notwithstanding the increasing convergence of market practice in New York and London for syndicated loans, differences remain. These differences are attributable to many factors, including different English and New York legal principles, expectations of market participants and, sometimes, habit. This article is the first in a series comparing syndicated loan market practice and underlying legal considerations in London and New York.

Aside from transactions such as credit default swaps and other derivatives instruments, the principle means by which lenders reduce existing credit exposure to borrowers is by assigning or transferring those credit exposures to other lenders or by selling to other lenders participations (in New York parlance) or sub-participations (in British parlance) in those credit exposures.

In the case of assignments and transfers, the assignee or transferee becomes the lender of record: it becomes a party to the underlying agreement and thereby comes into contractual privity with the borrower. But in participations (which term shall be used throughout this article in order to avoid repeated references to the different New York and London nomenclature), the participation agreement is solely between the lender of record and the participant and thus creates no privity between the participant and the borrower. Under the participation agreement the lender of record simply agrees to turnover to the participant whatever amounts it receives from the borrower.

The back-to-back approach of participations may be useful in overcoming obstacles that would prevent an assignment but not a participation, for example contractual limitations prohibiting assignments, regulatory requirements that apply to lenders of record, withholding tax treatment and the disclosure to the borrower, the administrative agent and other parties that would necessarily result from an assignment but not a participation.

Notwithstanding the same basic structure and business impetus for participations, the legal characterisation of these arrangements and some of their structural elements are different under English and New York law.

London

Under the form of participation agreement recommended by the Loan Market Association (LMA), which has been widely adopted in English law transactions, the lender of record (or grantor of the participation) undertakes to pay to the participant a percentage of amounts received from the borrower.

This form explicitly provides that "the relationship between the Grantor and the Participant is that of debtor and creditor with the right of the Participant to receive monies from the Grantor restricted to the extent of an amount equal to the relevant portion of any monies received and applied by the Grantor from any Obligor". The participation is thus substantively treated like the participant is financing the grantor's loan to the borrower, where the participant's right against the grantor for repayment is limited to funds received from the borrower. So if the grantor becomes insolvent, the participant holds no more preferred status as a creditor of the grantor with respect to funds received from the borrower than any other unsecured creditor of the grantor, and the Privy Council's judgment in Lloyds TSB Bank v Clarke [2002] UKPC 41 confirms that there is no doubt as to this treatment.

The risk of insolvency of the grantor presents not only the obvious commercial considerations, but, for banks that do not report in accordance with IAS, some accounting and regulatory issues referred to below. Although there are methods to structure transactions that enable participants to mitigate this risk, as described in some detail in the LMA's paper Funded Participations – Mitigation of Grantor Credit Risk, these methods add complexity to what many regard as routine trades and are not generally adopted.

The LMA's form of credit agreement does not address whether the grantor may vote its interest as directed by the participant. Absent special provisions in the credit agreement, the grantor would continue to vote and control its entire interest in the loan (including the portion subject to the participation). Where the participation relates to the grantor's entire interest in the loan, the grantor and the participant may agree that the grantor will exercise voting rights as directed by the participant, which may concern a borrower that was counting on its relationship with the lender of record. Conversely the inability of the grantor to split its voting entitlement where the participation does not relate to the whole of its interest may not be entirely satisfactory for the participant.

Absent clear provisions in the credit agreement dealing with pass through of increased costs, mandatory costs and the benefit of tax gross-ups and indemnities, the grantor is unlikely to be able to pass on to the participant the benefit of the provisions typically seen in the market.

New York

In New York, case law has developed that distinguishes between a "true participation" and a "financing". In a true participation, the participant acquires a beneficial ownership interest in the underlying loans. This means that the participant is entitled to its share of payments from the borrower notwithstanding the insolvency of the grantor (so the participant does not have to

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"A New York law participation agreement could provide an elegant alternative in the UK"

share those payments with the grantor's other creditors) even though the beneficial ownership does not create privity between the participant and the borrower. On the other hand, a participation that is characterised as a financing would have the same consequences as an English-law participation.

The most fundamental requirement for characterisation as a true participation is the effective transfer of the economic risks and rewards of ownership. Section 22 of the forms of participation agreements for par or near par trades and for distressed trades proposed by The Loan Syndications and Trading Association (LSTA) provide that "the relationship between [grantor] and [participant] shall be that of seller and buyer. Neither is a trustee or agent for the other, nor does either have any fiduciary obligations to the other. This Agreement shall not be construed to create a partnership or joint venture between the Parties. *In no event shall the Participation be construed as a loan from [participant] to [grantor]*." (emphasis added).

In the absence of the characteristics referred to below, courts would treat a participation sold under an LSTA form as a true participation. This is consistent with the position taken by the FDIC in its regulation 12 CFR 360.6, which provides that it will not use its authority to reclaim as property of an institution under conservatorship or receivership any financial assets transferred in connection with a participation, provided that the transfer meets all conditions for sale account treatment under US Gaap (other than a condition relating to "legal isolation").

Courts have held that the following four factors typically indicate that a transaction is a financing rather than a true participation:

(i) the grantor guarantees repayment to the participant;

(ii) the participation lasts for a shorter or longer term than the underlying loan that is the subject of the participation;

(iii) there are different payment arrangements between borrower and the grantor, on the one hand, and the grantor and the participant, on the other hand; and

(iv) there is a discrepancy between the interest rate due on the underlying loan and the interest rate specified in the participation.

Of these four factors, the guarantee of repayment is the most important in determining classification of a given transaction, because the failure by a participant to take the full risk of ownership of the underlying loan is a crucial indication of a financing rather than a true participation. Other factors indicating that a participant is not subject to the normal risks of ownership include guaranteed returns by the grantor and required repurchase arrangements.

Whether a participation is characterised as a true participation, which transfers beneficial ownership, or a financing, which does not, may also have other consequences. Of particular relevance for grantors that report under US Gaap, Financial Accounting Standards Board Statement 140 disallows grantors from taking off-balance treatment for loans subject to participations regarded as mere financings. In addition, whether or not a participant is considered to be the beneficial owner of a loan may have withholding tax implications under the laws of the jurisdiction where the borrower is located.

In contrast to the London market approach to voting by participants, a New York law credit agreement typically prescribes what a participant may vote upon. Even though the voting rights themselves are contained in the participation agreement (to which the borrower would generally not be a party) the credit agreement addresses this issue directly by prohibiting any lender from entering into a participation agreement entitling a participant to direct its voting, except as to certain matters. These matters are usually the same ones that would require unanimous consent or the consent of affected or directly affected lenders under the credit agreement.

Credit agreements in New York also generally address increased costs by participants directly. Since it is no longer the beneficial owner of the portion of a loan sold by participation, the seller is not likely to suffer increased costs from owning that portion of the loan and would have difficulty claiming indemnification for its own costs under the credit agreement. At the same time, a participant is likely to want the ability to recover any increased costs that it may suffer from being the holder of the participation. Accordingly, credit agreements frequently provide that participants may benefit from the increased costs indemnities, so long as the borrower does not thereby become liable to pay more than it would have paid in the absence of the sale of a participation.

Query

Given the advantages that a New York law participation agreement brings to participants (by mitigating credit risk of the grantor) and certain grantors (by better accounting treatment under US Gaap), can these advantages be realised by using such an agreement for a loan made under an English law credit agreement?

English courts should apply New York law to such an agreement and therefore give it the same effect that it would receive in a New York court. However, the English courts have not specifically considered this issue so one cannot be certain. It is possible that an English court would view the beneficial ownership conveyed under New York law as equivalent to an assignment (or, less likely, a declaration of trust). If the participation is construed as equivalent to an assignment under English law it is likely to be ineffective in practice unless contractual requirements with respect to assignments under the credit agreement are complied with. This uncertainty, however, should not adversely affect the treatment of that participation in relation to the possible insolvency of the grantor or the positive treatment under US Gaap.

This risk can be avoided if a credit agreement is drafted to ensure that New York law participation agreements (in an approved LSTA form) are a permitted form of assignment (as is the case for security assignments, which benefit from a specific exemption under the LMA's form of credit agreement). Where this is feasible, a New York law participation agreement could provide an elegant alternative worth considering.

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