

LMA Sub-Participation Agreements and Grantor Insolvency

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This memorandum provides an overview of the practical issues facing a sub-participant under a Loan Market Association ("LMA") English-law governed sub-participation agreement as the creditworthiness of grantor deteriorates.

In summary, where grantor is not yet subject to formal UK insolvency proceedings (administration or liquidation), there is no restriction on grantor's ability to conduct business in the ordinary course. It follows, therefore, that if sub-participant is concerned with grantor's ability to perform its obligations, sub-participant may generally "elevate" its interest in the loan and become a direct lender of record or request that the loan be transferred to a third party to allow sub-participant to enter into a new sub-participation arrangement with the third party in respect of the same credit agreement.

Where grantor is subject to formal insolvency proceedings and has filed for administration or liquidation, the ability of grantor to comply with sub-participant's request to elevate or transfer the loan position may be limited, since the business of grantor would then be subject to the control of the administrator or the liquidator.¹ In such instances, legal advice should be sought from an insolvency practitioner familiar with the multi-jurisdictional issues present in the secondary loan market in Europe.

Legal structure of LMA sub-participation agreement

Unlike most 'true sale' participation agreements used in the U.S. loan market, which grant in favor of the participant a beneficial or equitable ownership interest in the underlying loan, an LMA sub-participation agreement is characterized as a loan from sub-participant to grantor (in the amount of the purchase price) to be repaid solely to the extent the borrower makes payments on the underlying loan. Consequently, the sub-participation creates a debtor/creditor relationship between grantor and sub-participant. Under such arrangement, grantor is generally obligated to pay to sub-participant a pro rata amount equal to principal, interest, fees and other distributions received by lenders under the credit agreement.

Due to the nature of the sub-participation arrangement, (i) sub-participant is not a direct party to the credit agreement governing the underlying loan, (ii) grantor does not transfer or assign rights or obligations under the credit documentation to sub-participant, and (iii) sub-participant has no proprietary interest in either the loan or the credit documentation. Sub-participant therefore has a contractual nexus with grantor only, and has no direct rights against the borrower. Accordingly, in the event of the insolvency of grantor, sub-participant will

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¹ This memorandum assumes that the insolvency proceeding will be brought in the UK and will be governed by English-law.

(absent agreement to the contrary) merely have the right to claim as an unsecured creditor in the insolvency of grantor for unpaid amounts due under the sub-participation agreement.

Legal risks of sub-participant in grantor’s insolvency proceeding

In the event of the insolvency of a UK grantor, the sub-participation is subject to the control of the administrator or liquidator, as the case may be. The role of the administrator is to take control of the insolvent company and administer its assets in a manner which, if possible, preserves value, and to make proposals to the court and the creditors for the future of the company. In contrast, the role of the liquidator is to liquidate the assets of the company and to distribute proceeds to creditors and shareholders.

Whilst both an administrator and a liquidator have certain powers to set aside transactions on the grounds of preference and undervalue, as well as those that defraud creditors, only a liquidator has powers to disclaim onerous contracts generally. Therefore, absent any such circumstance, a failure by an administrator to perform under a sub-participation arrangement would constitute a breach of contract and give rise to a claim for damages by sub-participant. The ability to enforce such a claim would, however, be subject to the moratorium which arises upon the appointment of the administrator.

Given the lack of contractual nexus between sub-participant and the borrower in the context of the underlying loan, the borrower would continue to make payments to the insolvent grantor. Such payments, together with the underlying loan, would generally therefore comprise an asset in the estate of the insolvent grantor, and would not give rise to a claim by sub-participant on any other basis than that of unsecured creditor.

Mitigating the risks associated with a grantor insolvency

Trust or Collateral Arrangement

A Sub-participant may contend that the sub-participation gives rise to a trust in the proceeds of the underlying loan in favour of sub-participant. Such a characterization is difficult to support however as the sub-participation agreement often expressly states that nothing contained in the agreement constitutes grantor as “agent, fiduciary or trustee” for the Participant. Whilst there may be some merit in this argument in the context of non-cash distributions, the general nature of the sub-participation structure, i.e., of a loan from sub-participant to grantor, does not easily lend itself to such an interpretation.

Some participants request grantor to grant ancillary security over the proceeds of the loan in favour of a security trustee. In the event grantor enters into formal insolvency proceedings, the security trustee would hold the proceeds of the loan outside of the estate of grantor and on trust for sub-participant. The terms of such a trust would vary from case to case but such an arrangement would have the effect of reducing significantly the insolvency risk of grantor.

Elevation

Whilst there is no automatic right of sub-participant to unwind or elevate in the event of the insolvency of grantor, some market participants often include an “elevation” provision in the sub-participation agreement, which provision entitles sub-participant to request either (i) sub-participant be elevated to a lender of record position (giving it direct rights and obligations vis-à-vis the borrower), or (ii) the loan be transferred to a third party (with the intention that sub-participant enter into new a sub-participation with such third party).

In most LMA sub-participations, either party may request an elevation. The parties are required to use their “commercially reasonable efforts to, as soon as reasonably practicable..., cause sub-participant (or such other person as sub-participant may direct) to become a Lender under the Credit Documentation....” The transfer of the loan to sub-participant is subject to the provisions of the credit documentation and applicable law. Sub-participation agreements that permit elevation generally provide that the existing sub-participation arrangement will terminate on the effective date of the elevation -- the date designated as such by the agent under the credit documentation.

In order for elevation to occur, grantor will be required to execute a transfer certificate in the form prescribed by the credit agreement, either with sub-participant (if it is the party that will become the lender of record) or with the third party entity (for example, another banking entity that agrees to acquire the position from sub-participant, possibly with a view to granting a sub-participation to sub-participant).

Practical issues of an elevation

Clearly there will have been a number of reasons why a purchase was originally structured as a sub-participation. Such reasons will need to be reconsidered in the context of a subsequent elevation. Such issues include:

(i) **Qualifying Lender** – the credit agreement may contain contractual restrictions on eligible lenders of record. These restrictions are often linked to tax definitions and many buy-side funds find it difficult to take a direct participation in a loan.

(ii) **Regulatory** – in many jurisdictions, lending is a regulated activity. If sub-participant were to be elevated to the position of lender under a loan and were to assume a funding commitment under a loan, sub-participant may be deemed to be conducting a regulated lending activity that requires authorization.

(iii) **Consent** – some credit agreements require the consent of the borrower before a transfer of a loan can be effected, which consent may not be forthcoming.

(iv) **Tax** – depending upon the tax residency of the borrower and sub-participant, an elevation may, if sub-participant becomes a direct lender of record, lead to a disadvantageous tax treatment of any interest income under the credit agreement, including withholding etc. Some credit agreements will provide a gross-up for any such withholding but often the scope of the gross-up is limited. That said, the potential for any tax inefficiency will be balanced against the potential credit and performance risk of grantor not meeting its payment obligations under the sub-participation agreement, which risk may be further increased by grantor’s insolvency.

In circumstances where it is either disadvantageous or impractical for sub-participant to become a lender of record, it may be possible to (i) direct that the sub-participation be elevated in favour of the third party, and (ii) enter into a new sub-participation arrangement with the third party. Such an arrangement would have the effect of transferring the economic benefit of the loan without suffering any of the disadvantages considered above. Clearly the need to negotiate the terms of such an arrangement with a third party may delay prompt settlement but such a transfer would effectively mitigate the credit risk of the original grantor (although subjecting the sub-participant to the same risk of insolvency in relation to the new grantor).

Heightened risk associated with elevation in the context of grantor’s insolvency

Given the derivative nature of the LMA form of sub-participation agreement -- the underlying loan is the property of grantor -- there is a potential risk that the transaction would be unwound if the transfer or elevation were to occur on the eve of insolvency. An elevation, however, during a moratorium (being the

period after an administrator is appointed during which there is effectively a freeze on creditors taking action against the debtor) would, as a practical matter, require the co-operation of the administrator, and is therefore unlikely to be set aside at a later date (although an administrator's actions could always be challenged by either creditors or a liquidator on application to the court).

In the event that an administrator is appointed after an elevation, the administrator has the ability to review transactions for the period preceding the onset of insolvency (being at latest the date on which the application for administration is made, or notice of appointment is filed with the court)². The relevant period during which transactions may be reviewed is six months for transactions with unconnected persons and two years for transactions with connected persons.

If the administrator finds that there has been a "preference" – i.e. that grantor has taken an action or omitted to take an action that puts participant in a better position than it would have been absent the action or omission, and that grantor intended to prefer that creditor (e.g., it did not treat all participants in the same way and gave one party an improper advantage) then the participant bears a risk that an administrator may review the transaction and set it aside to restore the position as if grantor had not entered into the transaction (Section 238(3) Insolvency Act 1986).³

That said, it would be preferable to directly own the loan and run the risk of the transfer/elevation being unwound, rather than the potential risk of losing one's investment altogether in the insolvency of grantor.

Summary

In summary, in the event that a grantor suffers a deterioration of credit quality, in particular, if it may

lead to grantor entering into a formal insolvency process, a sub-participant should strongly consider mitigating the performance risk of grantor and the risk of becoming an unsecured creditor in grantor's insolvency by requesting an immediate elevation of any sub-participations. If such elevation is either not possible or undesirable, a sub-participant should also consider requesting a transfer of the lender of record position to a third party entity, with a view to negotiating and receiving a new sub-participation under such third party.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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² Section 240(3) Insolvency Act 1986.

³ This is similar to the preference concept under the U.S. Bankruptcy Code, which provides that a debtor or a trustee in bankruptcy may, subject to certain defenses, avoid transfers on account of an antecedent debt that are made within 90 days before bankruptcy (or one year if the recipient is an insider) if it permits the creditor to receive more than it would get in a chapter 7 (liquidation).