

The “Second Risk” that Keeps Loan Participants Up at Night

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Owners of bank loan participations take on two kinds of credit risk: (i) the borrower's failure to pay the underlying bank loan, and (ii) the loan participation grantor's bankruptcy. The first risk is well understood and carefully analyzed in each transaction. This memorandum focuses on the second kind of credit risk assumed by a participant – grantor insolvency.

The risk of grantor insolvency is especially significant in today's tumultuous market, where counterparty risk is heightened and assumptions about counterparty solvency are questioned as never before. This memorandum outlines the basic features of a loan participation and analyzes the legal decision-tree that would be used by a bankruptcy court to allocate proceeds of the grantor's estate among and between the grantor's loan participants and the grantor's creditors.

What is a Loan Participation?

Lenders routinely sell loans by participation. Credit agreements explicitly permit the sale of loans by participation. Hedge funds use participations as a trusted “fallback” method of purchase when a direct assignment of the loan is not possible, or to preserve anonymity in the credit. Lenders use participations to lay off risk while continuing a relationship with the borrower. The ubiquitous “loan participation agreement” has become an integral part of the increasingly liquid secondary loan market.

In the simple case, a lender, or “grantor,” grants an undivided “participation interest”

in an underlying loan to a “participant.” The grantor is then the only party with a direct contractual relationship with the borrower, by way of the underlying credit agreement. A loan participant therefore does not have a direct claim against the underlying borrower. Rather, the loan participant has only a contractual relationship with the grantor, which is established and circumscribed by the terms of the participation agreement.

Unfortunately, it therefore follows that if a grantor files for bankruptcy, a participant's right to receive payment on the underlying loan will continue to depend upon (and flow through) the grantor.

Whether a loan participant will be entitled to obtain the proceeds of the underlying loan paid by the borrower, as opposed to merely having the right to assert a claim in the grantor's bankruptcy as a secured or unsecured creditor, will depend on the specific language of the participation agreement.

A loan participant's rights and remedies in the bankruptcy proceeding of the grantor will depend on whether the participation agreement is characterized as (i) a true purchase and sale of an undivided interest in an underlying loan, or (ii) a loan from the participant to the grantor.

Is it a True Participation or a Loan?

To find a “true participation,” courts look for contract language showing a transfer of all beneficial and economic interests in the underlying loan from grantor to participant,

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leaving grantor with only “bare legal title” to the underlying loan.¹ Courts also look for evidence that the participation is a pass-through interest by examining whether (i) the term of the participation is the same as the term of the underlying loan, (ii) the payment terms in the participation agreement are the same as the terms in the underlying loan, (iii) the interest rate in the participation agreement is the same as the rate in the underlying loan agreement, and (iv) the grantor provided no enhancement or guarantee of the repayment of the obligations in the underlying loan.

If the participation is found to be a “true participation,” courts will likely determine that the participant holds an “ownership interest” in the underlying loan. However, because the grantor maintains record ownership of, and bare legal title to, the loan and the right to receive payment from the underlying borrower, any attempts by the participant to (i) take possession or control of the underlying loan or (ii) receive distributions directly from the borrower of the underlying loan will require relief from the bankruptcy court governing the grantor's estate.

Does the Participation Establish a Trust or Fiduciary Relationship?

A loan participant may contend the grantor should be considered a trustee holding the loan in actual or constructive trust for the benefit of the participant. Courts have held that a loan participation agreement may create a trust or fiduciary relationship between grantor and participant if the participation agreement clearly provides that the grantor holds the proceeds of the underlying loan “in trust” and “for the sole benefit” of the participant. Some courts have allowed a trust or fiduciary relationship to be inferred from the facts of the actual relationship between grantor and participant. Most courts have required that the

proceeds of the underlying loan be both (i) held in “trust” for the participant, and (ii) segregated in a separate identifiable account and not commingled with the grantor's funds.

If a court finds a trust relationship between grantor and participant, then, upon filing a motion for relief from the bankruptcy court, participant will likely be permitted to “elevate” the loan to a direct assignment (if allowed under the credit agreement), establish a direct relationship with the borrower and obtain any and all proceeds of the underlying loan from the grantor's estate, whether they were paid prior to or after the commencement of grantor's bankruptcy proceeding.

Can a Participant Obtain Relief from the Automatic Stay without Establishing a Trust?

If a participation agreement is a true participation but does not establish a trust relationship between the grantor and participant, then the participant still has several arguments to obtain control of the loan and loan proceeds from the insolvent grantor.

First, under Section 541(b)² of the Bankruptcy Code, a loan participant likely will be considered the beneficial owner of grantor's rights in the underlying loan. The grantor's bankruptcy estate will be considered merely the owner of bare legal title to the underlying loan and not the beneficial economic interest in the underlying loan.

Second, under Article 9 of the Uniform Commercial Code (the “UCC”), the sale of a “payment intangible” (which would include a loan participation) falls within the scope of Article 9 of the UCC. A participant purchasing an interest in a payment intangible should enjoy automatic perfection of a security interest in the

¹ For example, a typical participation agreement used in the secondary loan market will provide for a transfer of all beneficial and economic interests in the underlying loan by providing that “Seller irrevocably sells, grants and conveys an undivided 100% participation interest in and to the Loans, the Commitments (if any) and the Transferred Rights ... to Buyer.”

² Section 541 of the Bankruptcy Code provides that “Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate ... only to the extent of the debtor's legal title to such property, but not the extent of any equitable interest in such property that the debtor does not hold.”

payment intangible at the time of purchase *without any need to file a UCC-1 financing statement*.³

These two statutory provisions, taken together with the express language found in most secondary loan-market participation agreements,⁴ provide participant with a strong argument that (i) it is the beneficial owner of the underlying loan, (ii) such ownership interest was automatically “perfected” under Article 9 of the UCC without the need of any filing, and (iii) the grantor's estate has no equitable or beneficial interest in the underlying loan. As a result, the participant has good grounds to seek relief from the automatic stay and elevate the participation to an outright assignment of the underlying loan, provided that the participant is eligible to hold the loan as a direct assignee under the underlying credit agreement. Alternatively, if an elevation of the participation to an assignment is not possible or practicable, the participant may seek relief from the automatic stay to transfer the participation to an eligible assignee that is willing assume grantor's role under the participation agreement.

What if Payments on the Underlying Loan Have Been Paid to Grantor?

If payments on the underlying loan have been paid to the grantor before the participant obtains relief from the automatic stay, the participant is at risk if such proceeds are deposited in the grantor's general accounts and commingled with the grantor's other funds. In this case, the loan proceeds may not be “identifiable proceeds” and the participant's security interest in the underlying loan may not attach to such cash proceeds.

As a result, a participant with an insolvent grantor counterparty must vigilantly seek relief from the bankruptcy court immediately after bankruptcy proceedings begin. A participant may file a motion to

restrict grantor's ability to use the cash proceeds of the underlying loan under Section 363(e) of the Bankruptcy Code without first providing the participant with adequate protection of its interest.⁵ In connection with such a motion, the participant may request that the bankruptcy court require the grantor to (i) establish a segregated account in which the proceeds of the loan must be deposited, and (ii) make all payments of proceeds directly to the participant as required under the participation agreement until the underlying participation interest is elevated or transferred to another entity.

What if the Court finds the Participation is a Disguised Loan?

If the participation is not a sale or transfer of an ownership interest, it may be read to create a debtor/creditor relationship between the grantor and the participant. As discussed above, courts will characterize the participation on the basis of several factors, including whether grantor guaranteed any portion of the underlying loan and whether the interest rate or other terms in the participation agreement vary substantially from the underlying loan. Courts may also look beyond the participation agreement and examine the entire relationship between the participant and the grantor to determine whether the participation agreement should, in fact, be characterized as a loan.

If the participation is re-characterized as a loan, the court will not view the participant as having an ownership interest in the underlying loan and will likely not find an automatically perfected security interest under Article 9 of the UCC. In this case, a participant may be left with only an unsecured claim against the insolvent grantor's estate, unless the participant had otherwise previously been granted and perfected a security interest in the underlying loan.

³ Section 9-309 of the UCC provides that “The following security interests are perfected when they attach: ... (3) a sale of a payment intangible; (4) a sale of a promissory note.”

⁴ For example, a typical participation agreement provides that “Seller shall ... accept ... and... hold such Distribution for the account and sole benefit of the Buyer and ... have no equitable or beneficial interest in such Distribution.”

⁵ As discussed above, the cash proceeds constitute either (i) “cash collateral” by virtue of the automatically perfected security interest granted to participant at the time of the sale of the loan participation or (ii) assets belonging to participant.

To protect a participant against such a result, where it is less certain that the overall arrangement between the participant and the grantor will qualify as a true participation, the participation agreement should contain a protective grant of a security interest in the underlying loan. The participant should take steps to perfect such security interest by filing a UCC-1 financing statement.⁶

Conclusion

Loan participants bear two kinds of credit risk—borrower and grantor. While borrower credit risk is generally the focus of participant's investment decision, today's market makes clear that grantor (counterparty) credit risk should receive increased focus. The analysis of grantor credit risk may seem complex, but there are existing legal constructs that favor participants who are able to identify grantor credit risk and structure participation arrangements to reduce the economic downside of a grantor's insolvency and act vigilantly to protect their positions at the first sign of counterparty insolvency.

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⁶ To the extent the underlying loan is not fully funded but also comprises unfunded obligations, a participant will likely be wary of making payments to the grantor and may need to seek relief from the bankruptcy court to allow the participant to fund the required amounts either (i) directly to the borrower or (ii) to grantor into a restricted segregated account that could only be utilized to fund the required amounts to the underlying borrower under the loan agreement.