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Participation Trophies: Documenting and Negotiating Loan Participations

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As the secondaries market continues to grow and increase in complexity, we have noticed an uptick in interest among our clients in selling (and buying) loan participations. Participation arrangements can be a powerful tool for institutions on either side of the transaction – sellers can free up capital on their balance sheet, pare back funding obligations and reduce exposure to certain borrowers or industries, and buyers can get the economic benefit of a loan without having to manage a direct relationship with the borrower or comply with (typically more stringent) restrictions and consent requirements for direct assignments. Plus, while the transaction is undoubtedly complex, both parties can leverage the Loan Syndications and Trading Association's form documentation to keep attention focused on those provisions most important to their institution and the specific transaction. Done right, a bespoke participation arrangement lets everyone leave the field a winner (trophies optional).

Below we discuss broadly the participation structure and its benefits, typical principal documentation and some key considerations and commonly-negotiated provisions.

Participation Structure and Its Benefits

For the uninitiated, a participation is best understood in contrast with an assignment. Both are mechanisms by which a lender of record under a loan agreement (*i.e.*, the entity that is actually party to the contract as a lender) can transfer all or part of its interest in a funded or unfunded loan to a third party. However, unlike with an assignment (where the assignee steps fully into the shoes of the assignor as lender of record, and assumes direct contractual privity with the borrower and legal and beneficial ownership of the loan), the seller of a participation interest retains title to the loan and direct contractual privity with the borrower (*i.e.*, the participant does not become a lender of record under the loan agreement) along with certain rights and obligations, and the buyer of a participation interest assumes the economic benefits and risks. The contractual relationship for a participation is just between the seller and buyer – the borrower is not typically involved, and indeed is often not even aware of the transaction.

Among the benefits to sellers of loan participations, perhaps the most obvious is the cash received from the buyer upon settlement. Loan participations in the non-distressed secondaries space are often purchased for prices at or near par (*i.e.*, 100% of the principal amount of the debt participated), and that cash lands immediately on the seller's balance sheet. For unfunded loans, because the participation agreement obligates the participant to fund (or reimburse, depending on timing) future draws through the seller, a seller also benefits by shifting much of the responsibility to fund future draws to the participant (noting, of course, that this introduces new credit risk with respect to the buyer). In addition, regulated lenders are not typically required to hold capital against participated loans. Sellers can also realize value by retaining some of the economics of the loan they're selling a participation interest in. We see many participations where sellers retain some or all upfront fees paid by the borrower in respect of the loan, and a number where the buyer takes a haircut on the interest payments that are passed through to them, with the seller retaining the difference (noting that, if a seller is not passing along all or substantially all of the rights and obligations under the loan, the parties should carefully consider with counsel whether the sale would still be considered a true participation under New York law – if it wouldn't, buyer may be at risk of being considered a mere contractual counterparty of seller subject to seller's credit risk). Taken together, sellers can use participation arrangements to put cash on their balance sheets, reduce exposure to certain borrowers or industries and decrease regulatory capital obligations in compliance with internal or external requirements.

On the buyer's side of the transaction, buyers benefit from being able to realize some or all of the economic benefits of a loan without incurring origination expenses, the bulk of ongoing administration expenses or the legal expense associated with preparing the underlying loan documentation (subject, of course, to indemnities, etc., that can flow through to a participant, *e.g.*, agent expenses). From a credit perspective, depending on buyer's internal comfort level, a buyer can draft to varying degrees behind the seller's credit analysis and diligence of the borrower. In addition, since participants are typically not disclosed to a borrower, a buyer can generally keep its status as participant confidential.

Buyers and sellers alike benefit from not needing to seek consents and pay assignment or other fees that might be required in the case of a direct assignment.

Typical Principal Documentation

Sellers and their counsel typically hold the pen when documenting participation arrangements. While drafting parties can and do use their own forms, it often makes sense to leverage the Loan Syndication and Trading Association's (LSTA) standard form participation agreement for par/near-par (*i.e.*, non-distressed) trades as a starting point – even for bespoke, heavily-negotiated participations. The LSTA's form participation agreement was developed to facilitate efficient documentation of transactions in the high-volume secondary market (where participations are often used as a backup settlement option for debt trades that can't settle by assignment), and accordingly generally tracks market-standard terms and mechanics for participation arrangements. The LSTA form splits the participation agreement into two documents: (i) a longer set of standard terms and conditions (often referred to as STCs, and available here for LSTA members), which contains a baseline set of market-standard provisions, and (ii) a relatively short form agreement setting forth the transaction-specific terms of the participation (often referred to as the TSTs, and available here for LSTA members), which incorporates the STCs by reference and lets parties toggle on or off (often via checkbox), or otherwise supplement or modify, the various provisions of the STCs. The LSTA's bifurcated documentation pulls all the transaction-specific information, business terms and frequently negotiated provisions into a more manageable document.

Of course, there are a number of points in the LSTA forms that counsel will typically want to smooth out when using them outside of the more commoditized secondary loan trading market (*e.g.*, the need for trade confirmations and funding memoranda, delayed compensation, etc.). Nevertheless, starting with LSTA forms helps both buyer and seller cut down on legal expense, and focuses attention on the terms and provisions that are of particular importance to the parties and the specific deal. These efficiencies can also facilitate innovation.

Key Considerations and Commonly-Negotiated Provisions

Bespoke participation agreements are just that – bespoke. Cadwalader has helped clients tailor participation agreements to address a wide variety of institutional and business issues. There are a number of points, however, that come up with some frequency – below is a handful of examples.

Elevation. Buyer's rights to request "elevation" of its participation (*i.e.*, to seek to become a direct lender under the loan agreement) is often the subject of negotiation. Under the STCs, a buyer can always elevate if seller goes into bankruptcy. Otherwise, it's up to the parties – in some transactions buyers are free to elevate at any time. In others, elevations triggers are heavily tailored, and can include conditions tied to seller's credit rating, the amount of seller's loans or commitments under the facility, disputes over collateral value (particularly for participations in NAV loans) or the occurrence of certain events (or failures by seller to take certain actions) under the loan documents.

Voting. The voting provisions in the participation agreement govern whether, when and to what extent, the buyer can direct seller's votes as a lender under the loan documents. Participation provisions in loan agreements will sometimes limit a seller's ability to grant voting control to a participant beyond the typical suite of "sacred" provisions (*e.g.*, facility size, interest rates, payment dates, term, etc.). Otherwise, the parties can and do tailor the allocation of control to their liking – from no buyer voting rights at all to full buyer voting rights and everything in between. Buyers will often push for control over at least the "sacred" provisions in the loan documents. Sometimes buyers request decision-making power over waivers of certain events of default, facility subordination or other provisions important to the buyer's credit analysis or institutional concerns. If the underlying loan agreement does include limitations on the seller's ability to grant voting control, parties will typically clarify in the participation agreement that any voting rights allocated to buyer are allocated only to the extent it would not violate the loan agreement.

Sub-participations. One standard provision of the STCs we frequently see negotiated is the requirement that seller consent to a requested sub-participation by buyer "not be unreasonably withheld or delayed." Often, sellers will request that that language be deleted. Buyers, in turn, will request some exceptions (*e.g.*, permitting sub-participations to affiliates, if seller's hold on the facility drops below some specified amount, etc.).

Loan agreement diligence. Buyers and sellers should take care to consider the terms of the underlying loan documentation when documenting participation arrangements. Loan agreements in the secondaries market do not always include the detailed assignment and participation provisions lenders might expect in a loan agreement drafted with an eye towards syndication – indeed, it's not infrequent that we see loan agreements that are silent on the subject. Sometimes there will be credit agreement provisions that necessitate representations from buyer or seller (*e.g.*, a representation that buyer is not an affiliate of the borrower, not on a disqualified institution list or not otherwise an ineligible buyer) or explicitly require that seller maintain a participant register for tax purposes. While uncommon, credit agreements occasionally include borrower or other consent requirements for lender participations (and often the consequence for failing to obtain that consent is that the transaction is void). Additional complexities are introduced when participating in a bilateral loan – in the event a buyer wants to elevate its participation interest, significant revisions to the loan documents may be required to accommodate a multi-lender structure. Often specifically tailored provisions are required in the participation agreement to address a given loan agreement.

The above is just a sampling of bespoke provisions Cadwalader has handled in the market – everything from dispute mechanics, rights of first refusal/offer, elevation facilitation, heightened standards of care, tag alongs, etc., have crossed our desks. Even using the LSTA forms to create aircraft carrier-esque master participation agreements that function as platforms for participating multiple loans between institutions (rather than just one loan participation per participation agreement).

Conclusion

Participation arrangements, particularly those that leverage LSTA documentation, offer buyers and sellers quite a bit of deal-making flexibility and opportunity, and the above is just an overview. It is important to seek guidance from counsel and address the particular nuances of the deal at hand. Cadwalader, of course, is happy to assist should your institution choose to participate in a participation.