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Transfer restrictions may create additional counterparty risk for distressed debt investors

KEY POINTS

- Borrowers are pushing origination banks to tighten transferability language and extend their consent right to include participations and other types of transfers.
- A borrower may have regard to maintaining "control" over its lender group when withholding consent to a debt transfer.
- European loan traders must actively manage borrower consent and settlement risk on a case-by-case basis.

Experienced European loan traders know that borrowers and sponsors may be concerned about perceived "aggressive" investment funds buying into their debt, either directly or via sub participations. As a result, when European borrowers receive a request for an investment fund to enter their lender group via a secondary market transfer, they are increasingly using their consent rights to deny the request and maintain control of the make-up of the group. In many cases, the loan agreement requires the borrower not to unreasonably withhold consent to the transfer; but what constitutes "consent being unreasonably withheld" is an unsettled point of English contract law, which governs many loan agreements across Europe. Further, borrowers are pushing for a tightening of the transferability language and extension of their consent right to include participations or other types of "transfers", potentially further clouding how a secondary market trade will settle.

In many instances, a buyer will confirm a bank debt trade prior to understanding the transfer risk on a particular name. What happens when a fund confirms its purchase of bank debt and the borrower subsequently withholds its consent for the fund to become a lender of record? The fund may be forced to settle by participation which, in Europe, is structured as a derivative relationship. In this context, the seller is delivering an unsecured claim to a buyer against the seller referencing the underlying borrower and lender relationship. In contrast, the US form of "true participation" is intended to vest the buyer with an ownership right in the proceeds the lender paid to the borrower and then passed them to the participant. European loan traders need to be cautious as they are more likely to end up as a participant due to consent being withheld by a borrower, which results in:

- double credit risk (from the seller and the borrower);
- no privity with the borrower or ability to be active in a restructuring; and
- a potentially less-liquid position than being in senior secured bonds or, for that matter, a lender of record.

STATUS OF PARTICIPATIONS IN UK V US (LMA V LSTA)

The Loan Market Association (LMA) and Loan Syndication and Trading Association's (LSTA) mandatory settlement provisions dictate that if a trade cannot settle by legal transfer, there will be an automatic "fall-back" to settlement via funded participation or other economic equivalent.

LMA participations

The LMA form of funded participation is governed by English law and contemplates a debtor/creditor relationship between the seller (grantor) and buyer (participant). Under this type of arrangement, the buyer has no beneficial interest in the underlying loan agreement, nor any relationship with the borrower. Instead, the buyer has only a right to receive the economic equivalent of any payments made by the borrower under the loan agreement to the seller, with the seller passing on such amounts to the buyer pursuant to the terms of the participation agreement. As the participant (the buyer) has no interest in the underlying debt or loan agreement, it has no contractual standing against the borrower if the borrower defaults under any of its payments. Additionally, the buyer also bears credit risk exposure against the seller, should the seller become insolvent during the life of the participation. In such a scenario, the buyer only has an unsecured claim against the seller under the funded participation and cannot claim a proprietary interest or entitlement in, or to, the underlying loan proceeds or security granted under the loan agreement. The result of this structure for the buyer is a "double credit risk" scenario, placing the buyer in an inherently more risky position than if it were to become a lender of record or if it had acquired the bank debt by way of an LSTA "true participation" arrangement.

For many investors, the increased counterparty credit risk, decreased control and decreased liquidity resulting from an LMA funded participation is enough to ruin the investment – and the trade has not even yet settled.

LSTA participations

The LSTA form of funded "true participation" is a New York law governed structure, intended to give the buyer an ownership interest in the actual proceeds paid by a borrower to the seller. Whether a participation constitutes a "true participation" under New York law is a fact-based analysis that takes into account various factors including:

- the relevant language of the underlying agreement;
- the amount of control the seller retains or is perceived to retain over the assets after the closing of the relevant transaction; and
- whether the transaction shifts the risks of

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loss and/or benefits of ownership to the transferee.

The LSTA form intends to meet this criteria and assign to the participant all of the rights of the grantor to payment under the loan agreement. In the event that the grantor becomes subject to insolvency proceedings, payments are intended to be isolated from its insolvency estate, resulting in more limited counterparty credit risk for a participant under a "true participation."

This LSTA true participation structure was recently tested and proven effective in the Chapter 11 case of *Lehman Brothers Commercial Paper*, when the Bankruptcy Court issued an order establishing that "all cash, securities and other property distributed or payable in respect of true participations… are not property of the debtor's estate and shall be promptly turned over to the beneficial holders thereof." LMA participants were not granted the same protection. (See *In re: Lehman Commercial Paper Inc, 08-13900* (SDNY Oct 6, 2008) (Order Pursuant to ss 105(a), 363(b), 363(c), and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing Debtor to (A) Continue to Utilize its Agency Bank Account, (B) Terminate Agency Relationships)).

"A TRADE IS A TRADE"

Investors should be especially cautious regarding the purchase of bank debt because the general practice in both the US and UK secondary bank debt and claims trading markets, is that a trade is binding upon oral or written agreement on material terms. (See N.Y. Gen. Oblig. Law § 5-701(b)(2)(i) and (ii), and the recent UK decision of *Bear Stearns v. Forum Global Equity* [2007] EWHC 1576 (Comm), in which the court confirmed the binding nature of a telephone conversation between traders agreeing to terms of a purchase of *Parmalat* notes.) In other words, "a trade is a trade". The risk for an investor is that if you are forced to settle by way of participation, you will not end up with what you thought you originally agreed.

BORROWER WITHHOLDING CONSENT

In 2014, borrowers are taking more aggressive steps, not only to control their lender group, but other forms of economic participations and voting rights. While many loan agreements stipulate that borrower consent cannot be "unreasonably withheld", the historic lack of case law establishing what constitutes "unreasonable" behaviour in a commercial context leaves investors unsure as to whether they have legitimate grounds for challenging a borrower's refusal of consent.

A recent UK case – in which a potential borrower sued Terra Firma Capital Partners (the private equity owners of Tank & Rast Holding GmbH, a German infrastructure group) in the High Court for denying borrower consent to a competitor to whom Terra Firma did not want to provide access to syndicate confidential information – was unfortunately settled out of court without any guidance from the High Court on whether Terra Firma had legitimate grounds to withhold consent. However, in the recent decision of *Commercial First Business Limited v Anthony Henry Atkins* [2012] EWHC 4388 (CH) the High Court reiterated the guidelines for determining whether consent had been unreasonably withheld (these guidelines were also followed in *Porton Capital Technology Funds and others v 3M UK Holdings Ltd and 3M Company* [2011] EWHC 2895 (Comm)).

Applying these guidelines to secondary bank debt transactions, where borrower consent is withheld and subsequently challenged as being unreasonable, the following approach may be used by the courts when making a determination:

- the burden is on the proposed new lender to prove that withholding of consent by a borrower was unreasonable;
- a borrower does not need to show that its refusal of consent was right or justified, simply that it was reasonable in the given circumstances;
- in determining what is reasonable, the borrower may have regard to its own interests;
- a borrower with consent rights is not required to balance its own interests with those of the proposed new lender, or to have regard to the costs that the proposed new lender might be incurring.

While there is still little case law on this approach, the findings in *Porton* and *Commercial First* merit attention from the bank debt community as to difficulty around challenging borrower consent refusals for an English law governed loan agreement. If borrower consent is not obtained, the assignee will often rely on settlement via participation, sub-participation or some other alternative mutually agreed-upon structure, the pitfalls of which are discussed above.

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INVESTOR TAKE-AWAYS

While investors can attempt to negotiate additional terms at the time of trade, that enable them to walk away from a trade if legal transfer cannot be effected, this will likely be met with significant resistance and difficult to achieve as standard operating procedure. Alternatively, if the overall aim is to take on larger bank debt exposure against a particular borrower, it may be best to commit to a minimum threshold piece first, as a way to discern how easily it can settle the trade by way of legal transfer rather than by way of participation. However, it is important to note that in many European loan agreements , an existing purchase does not grant lenders an automatic right to increase their position and bypass borrower consent. Ultimately, like many European trade issues, borrower consent risk needs to be actively managed on a case-by-case basis. It is crucial for investors to begin to address this issue before saying "done" or they will be fighting an even steeper uphill battle with both their counterparty and the borrower. ■