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PROMOTING LIQUIDITY IN THE SECONDARY LOAN MARKET: IS SUB-PARTICIPATION STILL FIT FOR PURPOSE?

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Abstract

One of the most innovative features of the international syndicated loan market, almost since its inception, has been the transformation from loan assets which are held, historically by banks, until maturity, to the creation of assets which are highly liquid and tradeable as if they were securities. The various techniques deployed by market participants to achieve such liquidity and transferability, and attempts by borrowers to restrict it, have been subject to almost constant change. This article will consider whether recent developments in the market, specifically with reference to sub-participations, are now inhibiting liquidity and transferability.

Introduction

A secondary market in loan assets has existed for as long as banks have originated loans but it is only relatively recently that a more coherent approach has been developed to the trading of such assets. That approach started in the early 1980's[2] during the sovereign debt crisis and was given additional impetus by four key developments: the first was the development and implementation in the mid 1980's of what was known at the time as "the Basel Capital

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[2] In a discussion paper published in March 1985 the Bank of England noted that activity [in the secondary market] seems to be small in relation to the stock of credits outstanding but also noted "several large banks have recently developed active asset sales programmes, which suggests activity may be increasing" specifically with reference to "secondary trading of participations [which] is becoming an explicit balance sheet management tool", Bank of England Discussion Paper No. 22; "The Syndicated Credits Market" March 1985.

Convergence Agreement",[3] which set out the original text of the so-called Basel Capital Accord (or Basel I, as it later came to be known), aimed at applying, for the first time, common minimum capital standards to the international banking sector. It is difficult to overstate the importance of this regulatory development, and the subsequent standards issued by the Basel Committee[4], to the development of a more coherent secondary market in loan assets[5]. A second key driver has been the dramatic change in the type and number of parties which trade such assets. The secondary market was initially primarily an interbank market dominated, certainly in terms of the origination of loans that were traded, by a small number of large, primarily US, banks, but that changed in the early to mid-1990's when institutional investors and other non-bank financial institutions were increasingly attracted by the senior secured, floating rate, term loans originated in the primary market. Today, the range of loans traded in the secondary market is even broader and includes leveraged finance loans which have increasingly dominated the market[6]. Those loans are both originated[7] and bought by a diverse range of parties including banks, hedge funds, pension funds, structured special purpose vehicles, including CLO's, insurance companies and vulture funds[8]. This broader base of investors fuelled a significant increase in the volume of both par and distressed loans traded in the secondary market which has continued to this day. A third important driver was the development, in the late 1980's, of a financing technique we know today as securitisation

[3] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards" (July 1988).

[4] Basel II (June 2004) and Basel III (December 2010). Basel IV, which will require a further significant increase in bank capital, was due to be implemented in January 2022 but implementation has been delayed in response to the Covid-19 pandemic until January 2023.

[5] The supervisory framework developed by the Basel Committee has also had a significant impact on the primary market by forcing regulated banks to reduce their lending activities to meet stringent capital requirements. That has resulted in institutional investors expanding their participation in all sectors of the primary market, particularly those, like the leveraged loan sector, which offer higher returns. That will undoubtedly continue following the implementation of Basel IV in January 2023.

[6] Over the past two decades the European Leveraged Loan Market has developed into an annual €200bn asset class and leveraged loans have for some time comprised the most frequently traded loan in the secondary market, see EME Secondary Loan Trading Volume Survey https://www.lma.eu.com accessed 1st August 2021. For an interesting review of the current European Leveraged Loan Market see 'Leveraged Finance: Thematic Note EBA/RER/2021/21 published by the European Banking Authority https://eba.europa.eu

[7] Loans origination in the leveraged finance market over the past two decades has been increasingly dominated by institutional investors which now account for over two thirds of primary issuance, see S&P Global Report: 2021 Outlook: European leveraged loan market eyes surge due to M&A pick-up, Author Nina Flitman (published 16 Dec, 2020) https://www.spglobal.com; M&G Investments: 'Leveraged loan market outlook – What will 2021 bring?' https://www.mandg.com; and M&G Investments: 'Comparing the investment cases for European and US Leveraged loans', (published May 2018) https://www.mandg.com.

[8] Loan Market Association "Guide to Secondary Loan Market Transactions" (2018).

and which, as originally conceived, focussed on the repackaging of bank financial assets into securities thereby effectively enabling such assets to be traded in the international capital markets. The earliest securitisation transactions in Europe coincided with the implementation of the Basel I regime, referred to above, and securitisation was quickly recognised as an effective way for banks to manage some of the implications of the new regime[9]. The final important driver was the creation, in December 1996, of the London based Loan Market Association ("LMA") by banks operating in the European, Middle East and African ("EMEA") markets, which followed shortly after the creation of the New York based Loan Syndication Trading Association ("LSTA") in the US[10]. The principal aim of both the LMA and the LSTA is to promote liquidity in both the primary and secondary loan markets and, in order to achieve that aim, both bodies publish precedent form documents and associated guidance notes which are now widely used in the origination and trading of loans.

Methods of transfer

The numerous legal, commercial and regulatory challenges facing banks wishing to transfer loan assets has resulted in many innovative techniques[11] being developed to facilitate the "sale" or transfer of such assets or the exposure to them, however, three methods[12] have dominated the market since its inception, namely novation, assignment and participation[13] and of those three the most innovative, and probably the most popular, has been participation, better known in the European market as 'sub-participation'. For reasons that are considered in greater detail below, the original structure of sub-participation agreements enabled lenders to address a number of significant legal and commercial challenges that were not capable of being dealt with by transfers made by way of novation or assignment.

[9] For a more detailed analysis of the origins of securitisation and the Basel regulatory regime, see G. Penn & T. Papadogiannis 'Regulating Securitisation in the Aftermath of the Global Financial Crisis: Lessons from Europe' [2021] 36 JIBLR 225.

[10] The LSTA was created a year earlier, in 1995.

[11] For a more detailed account of the development of those techniques see*:* Penn, Shea & Arora, "The Law & Practice of International Banking" (1st edn 1987) Chap. 8.

[12] Other methods include transfers by way of trust (see G. Penn, S. Smith and S. Hawkins, 'Don King – Panacea or Poison?' [1999] 14 JIBLR 316 (Sweet & Maxwell); proceeds assignment; and broking (see Penn, Shea and Arora supra n.8 above).

[13] Norton, Rose, Botterill & Roche 'Selling Loan Assets under English Law: A Basic Guide' IFLR, May 1986 26-31, M. Allen, 'Asset Sales – An Analysis of Risk for Buyers and Sellers' [1987] 1 JIBL 13.

However, over recent years a number of further innovative features have been added to the original structure of sub-participation agreements and some of these have resulted in material changes to the commercial objectives and legal substance of these contractual devices. Some of those features are now inhibiting the use of this highly flexible and innovative method of transfer and raise concerns about the future liquidity of the secondary loan asset market.

The original structure and purpose of English law governed sub-participation agreements

Although a form of sub-participation had been used in the US for many years[14] it was not used as a method of transfer for loan assets in Europe until the 1980's when, as already indicated, the primary market was dominated by a relatively small number of large, primarily US, banks. Those banks enjoyed a near monopoly over lending relationships to the best corporate and sovereign borrowers and, while they were willing to allow others[15] to participate by sharing the credit risk (and reward) of such relationships, they did not wish to do that in a way that might jeopardise their dominance of the primary market or their relationships with their prized borrowers. The solution was a method of transfer based largely on the US form of participation agreement but which afforded greater protection to the relationship between the original lender (which shall be referred to as the "**Lender of Record**"[16]) and the borrower, hence the birth of the English law governed sub-participation.

How did the English law governed 'sub-participation' differ from its US counterpart?

[14] In the US market the agreements are typically referred to as participation agreements. For an interesting analysis of the development of participation agreements in the US see A. Armstrong, 'The Developing Law of Participation Agreements', [1998] 23(3) Bus. Law 689.
[15] At the time buyers in the secondary market were primarily banks.
[16] For the purpose of this article this definition will also be used to cover the situation where a party becomes a 'Lender' as defined in the relevant underlying loan following transfer to it of a participation in that loan, by way of assignment or novation, in accordance with the market standard 'Changes to the Lenders' provision typically included in LMA style loan agreements.

Although some commentators[17] continued to question the legal nature of US style[18] participation agreements, by the time English law governed sub-participations were first developed, it was fairly well settled that the typical wording of agreements entered into under New York law transferred a beneficial interest in the underlying loan and/or the proceeds in favour of the sub-participant. Some of the cases characterised the interest as akin to a partial assignment[19] whereas others recognised that a trust had been created over the proceeds paid by the borrower[20]. Either characterisation provided protection to the sub-participant against the insolvency risk of the Lender of Record and also gave the participant an interest in the underlying loan, or at least its proceeds, depending on the specific wording of the agreement[21].

Creating some form of legal or beneficial interest in the underlying loan and/or or its proceeds, in favour of the sub-participant, was not the intention under English law governed agreements. As previously stated, the banks which dominated the primary market in the mid-1980's had no desire to create any proprietary interest in favour of the sub-participant that might impact, adversely or otherwise, their relationship with the borrower. The objective was to transfer only an economic interest in the loan. This was achieved by the Lender of Record (the 'grantor' of the sub-participation as it became known) and the sub-participant entering into an entirely separate agreement which, although linked to the underlying loan, was legally independent of it. This independent and purely contractual arrangement did not (and was not intended to) transfer any legal or beneficial interest in the underlying loan or its proceeds to the sub-participant and, as a consequence, the sub-participant was not able to

[17] See: A. Armstrong, 'The Developing Law of Participation Agreements', [23] The Business Lawyer 3 (April 1968) 689; Behrens, "Classification of Loan Participations following the Insolvency of a Lead Bank", 62 Texas Law Review 1115; Desjardins, "Assignments and Sub-Participation Agreements – A Basic Overview" [1986] The Canadian Bar Review 224; D.L. Threedy, 'Loan Participations – Sales or Loans? Or Is That The Question? 68 OR.L. Rev. 649 (1989); and T. Albrecht and S. Smith, 'Corporate Loan Securitisation: Selected Legal and Regulatory Issues' 8 Duke Journal of Comparative & International Law 411, at pp442-447.

[18] One of the earliest transactions in which a US form of sub-participation was used related to a US$50 million loan arranged by the National City Bank of New York and made available to the Imperial Russian Government; see *Miller v National City Bank*, 166 F.Zd 723 (2d Cir 1948). New York law was most frequently chosen as the governing law of such agreements.

[19] In *Re Westover Inc.* 82 F. 2d 177 (2nd Circ. 1936).

[20] See *Stratford Financial Corp. v. Finex Corp* 367 F. 2d 569 (2d Cir. 1966) and *Re Alda Commercial Corp.* 327 F. Supp, 1315 (S.D.N.Y. 1971). Both cases are analysed in detail in Simpson D., 'Loan Participation: Pitfalls for Participants', 31 The Business Lawyer 4 (July 1976) 1977.

[21] R. Ryan Jr, Participations in Loans under New York Law, 3 IFLR (1984) 40.

exercise any rights against the underlying borrower; no privity of contract was intended to be created between the borrower and the sub-participant. The sub-participant's rights were solely against the Lender of Record and the nature of that relationship was one of creditor and debtor respectively. The original form of English law governed sub-participation was a classic derivative contract intended to mimic the economic effect of the underlying loan contract but giving the sub-participant no rights in that contract. However, there was one important distinction between sub-participation and many classic derivative contracts; the requirement for the Lender of Record, in all cases, to own the reference asset upon which the derivative contract was based, namely the underlying loan[22]. That requirement effectively prevented sub-participation agreements creating a synthetic exposure in the underlying loan. Representations made by the Lender of Record addressing this requirement were included in the earliest forms of sub-participation agreements and those now typically extend to extensive 'predecessor-in-title representations', often tracing ownership back to the inception of the underlying loan where the Lender of Record is not the original Lender[23]. Those representations also typically extend to no encumbrances, no prior sale, no impairment, no default[24] and alienability[25]. Ownership of the relevant 'reference asset' is not required in many classic derivative contracts, which are often entered into for purely speculative purposes, and it is the ownership by the Lender of Record of the underlying loan, and the potential impact that ownership has on the position of both the sub-participant and the borrower, that is at the core of many of the problems highlighted in this article.

The regulator gave early approval to sub-participation as an effective method of 'transfer' for bank regulatory purposes

The original form of English law governed sub-participation not only achieved the legal and commercial objectives of banks which dominated the primary lending market at the time, it

[22] Although one of the parties, the protection buyer, for example, in the case of a credit default swap ("CDS"), may own the reference asset, it is not required to do so. Many CDS contracts are entered into for purely speculative purposes.
[23] See LMA 'Secondary Debt Trading Documentation/Par and Distressed Users Guide' published 18 December 2019.
[24] In the case of a par sale.
[25] An extensive set of representations given by the Seller [Lender of Record] is included at p.60 (para (D)) of the LMA Users Guide supra n.22.

also received the blessing of the Bank of England, the lead UK bank regulator at the time, by enabling the Lender of Record to remove the exposure to the borrower on the underlying loan from its supervisory balance sheet. That exposure was instead included in the sub-participant's balance sheet as a claim on the underlying borrower. As early as 1987, the Bank of England published a consultative paper entitled 'Loan Transfers and Securitisation'[26] setting out the Bank's understanding of the legal classification of sub-participation agreements customarily entered into at the time. The legal analysis included in that consultative paper, which underpinned the Bank's supervisory policy on the treatment of loan transfers, stated that sub-participation agreements customarily entered into at the time gave rise to "a separate legal agreement from the underlying loan, creating a debtor-creditor relationship between buyer and seller. The buyer does not (or at least is not intended to) acquire any legal or beneficial interest in the underlying loan, nor any contractual relationship with the ultimate borrower"[27]. This characterisation of sub-participation as a separate debtor-creditor relationship in which the sub-participant acquires no legal or beneficial interest in the underlying loan and no legal relationship with the borrower was also applied by the Privy Council in one of the few English law cases on sub-participation[28]. Although the underlying transaction to which the sub-participation referred in that case was a note issue, as opposed to a loan, the wording of the sub-participation agreement was consistent with the language initially adopted by the market. That wording "was intended to have the effect of a back-to-back, non-recourse, funding arrangement which created a debtor-creditor relationship without giving the sub-participant any interest in the underlying loan"[29]. The obligation of the Lender of Record to pay the sub-participant was triggered only in the event the borrower makes a payment of principal and/or interest to the Lender of Record[30], however, critically, that payment to the sub-participant comes from the Lender of Record's own funds; the Lender of Record does not hold payments received from the borrower on trust for the participant, nor is there an assignment of any interest in the loan or its proceeds. The Privy Council recognised there might be an assignment or a trust if it was the intention

[26] Bank of England, Banking Supervision Division, Notice to Institutions Authorised under the Banking Act 1987: Loan Transfers and Securitisation, BSD/1989/1.
[27] ibid, para 24.
[28] *Lloyds TSB Bank plc v Clarke and another* [2002] UK PC 27
[29] ibid at [28].
[30] *Adolfo Attman v Australia and New Zealand Banking Group* [2002] EWHC 2488 (Comm) at [18], citing Penn, Shea and Arora supra n.10.

for the sub-participant to acquire a right to payment out of the funds actually received by the Lender of Record from the borrower but the wording of the agreement, which was consistent with market practice at the time, made clear that was not the case. The payment from the borrower was **the measure** but critically **not the source** of the funds: "[the Lender of Record] shall remit to the [sub-] participant such amount….such amount being equal to the amount so received or recovered [by the lender of record from the borrower]"[31].

The Privy Council also held that "although the term 'sub-participation agreement' is not a legal term of art like 'assignment' or 'trust'. It is, however, a term commonly used in the market"[32]. However, to simply label an agreement a 'sub-participation' was not conclusive. "The legal rights and duties created by the contract were a matter of construction for the court and although there were "linguistic inconsistencies" in the sub-participation agreement, those "cannot detract from the clear and uncompromising language of cl 2"[33], which the Privy Council considered to be the main operative clause in the agreement establishing the sub-participation as a classic debtor-creditor relationship giving the sub-participant no proprietary interest in the underlying loan.

The effectiveness of the original form of sub-participation in maintaining the relationship between the Lender of Record and the borrower, by ensuring no rights in that loan were transferred to the sub-participant, whilst still enabling the Lender of Record to achieve complete regulatory relief, by removing the loan[34] from its regulatory balance sheet, resulted in sub-participation quickly becoming the preferred method of transfer in the secondary market.[35] This was particularly the case for banks with borrower relationship concerns or

[31] Supra n. 27 at [32]. The Privy Council also rejected the argument that it would be unconscionable for the lender's liquidator to retain funds intended for the sub-participant: "there is nothing unconscionable about requiring [the sub-participant] to share pari passu in the distribution of [the lender's] assets like any other unsecured creditor" at [27], per Lord Hoffman. In *Re Japan Leasing (Europe) plc* [1999] B.P.I.R. 911, an agent was appointed to receive payments due under a sale contract and to pass them to the seller; on the agent's insolvency the court held that, although the agreement had excluded any trust arising from the contract, the payment was subject to a constructive trust for the benefit of the seller. It is significant that, unlike the situation in a sub-participation agreement, the wording of the relevant agreement required the payments received to be passed to the seller and that entity was an agent.
[32] Supra n.27 at [15], per Lord Hoffman.
[33] Supra n.27 at [25].
[34] Or the relevant part thereof if only part of the loan was sub-participated.
[35] Supra n.1.

where the underlying loan included restrictions[36] on the ability of the lender to transfer the Loan by way of novation or assignment. Since the original form of sub-participation did not create any rights over the underlying loan; no privity of contract between the sub-participant and the underlying borrower; and gave rise to a purely contractual, debtor/creditor, relationship between the lender and the sub-participant, such methods of transfer were largely ignored by borrowers during the initial development of transfer restrictions in primary loan market agreements[37].

Additional risks associated with transfers by way of sub-participation were recognised early and did not undermine its use

The fact that sub-participation was considered to be the optimal method of transfer from a lender/borrower relationship perspective did not, however, result in it being considered optimal in all respects. It was well recognised from the outset that transfer by way of sub-participation presented additional risks, not typically present in transfer by way of novation or assignment, particularly in the context of 'double jeopardy' or 'double credit risk' as it later became known[38]. In its first Notice[39] setting out the Bank's supervisory policy on sub-participations, the Bank of England highlighted the double credit risk to which the sub-participant would be subject and required the sub-participant, "as a matter of best practice", to mitigate that risk by taking a charge over the underlying loan. The risk was reinforced with the warning that "The Bank may require justification where this is not done"[40]. Ignoring the fundamental problem that, under the terms of a typical sub-participation agreement, any such charge would have no real equity of redemption[41] and therefore would likely be unenforceable, the banks which dominated the primary loan market at the time did not find

[36] For an interesting analysis of the various forms of transfer mechanisms developed in the early 1980's see Bray, "Developing a Secondary Market in Loan Assets". IFLR October 1984, 22; and Hughes, "Transferability of Loans and Loan Participations, [1987] 2 JIBL 36.
[37] This has recently changed and the issue is considered in greater detail under "Restrictions on Sub-Participation" below.
[38] See Bank of England Consultative Paper supra n.25 at p.8.
[39] Supra n.25 at para 7(iv). For a more detailed analysis See also M. Daley, "Funded Participations – Mitigation of Grantor Credit Risk [2009] JIBLR 288.
[40] ibid.
[41] For a more detailed analysis see M. Daley, 'Funded Participations – Mitigation of Grantor Credit Risk' supra n. 38.

this proposal attractive. That reaction was predicted by the Bank in its original consultative paper[42] although the reluctance was driven more by the unwillingness of banks, whose very success depended on market confidence in their credit risk, to be seen to be granting a registrable change to provide protection against that very risk. The proposal was formally withdrawn by the Bank in 1992 following market criticism and no additional regulatory consequences were imposed upon the sub-participant to reflect the double credit risk to which it was exposed. Exposure to the underlying borrower was required to be included in its regulatory balance sheet but nothing more[43].

Sub-participation was an important contributor to the initial development of the securitisation market

So by the early 1990's although English law governed sub-participation agreements were bespoke documents, drafted on a case by case basis, their commercial objective and legal effect was fairly well settled and reflected the characterisation made by the Privy Council in the Lloyds TSB Bank case[44]. The key commercial objectives were to ensure the credit risk in an underlying loan was transferred from the Lender of Record to the sub-participant in such a way that did not impact the Lender of Record's relationship with the borrower and which relieved the Lender of Record from the regulatory capital carrying cost of the underlying loan. The structure of such transactions was in many ways remarkably simple: a purely contractual, back to back, arrangement between the Lender of Record and the sub-participant which derivatively transferred both the credit risk and reward in the underlying loan from the Lender of Record to the sub-participant[45]. So successful was sub-participation in achieving the key commercial objectives of lenders that it quickly became the favoured method of 'transfer', not only in relation to the transfer of individual loans but also in respect of the nascent, bank originated, corporate loan securitisation market.

[42] Supra n.25 at para 29.
[43] Amendments to the Bank's Notice 'Loan Transfers and Securitisation' (BSD 1989/1), BSD 1992/3.
[44] Supra n.27.
[45] Some early forms of English law governed sub-participation agreements characterised the amount paid by the sub-participant as a limited recourse deposit i.e. one repayable only to the extent the borrower makes repayments to the Lender of Record on the underlying loan and therefore treated, for regulatory purposes, as a claim collateralised by cash which is 0% risk weighted. See T. Albrecht and S. Smith *supra* n.16 at p.443.

Prior to the NatWest Bank originated Rose Funding No. 1 Limited securitisation ('Rose Funding') in 1996[46], banks had been reluctant to securitise corporate loans they originated for fear of adverse reaction from their corporate 'relationship' customers. Transferring the loans by way of sub-participation was seen as the optimal way to address that concern; the Lender (NatWest in the case of Rose Funding) remained the legal and beneficial owner of the loans and retained full relationship control in dealings with the underlying corporate borrowers. The sub-participant, the SPV, Rose Funding No. 1 Limited, obtained no rights against those borrowers[47]. The rights it did enjoy were solely economic, derivative style, rights which effectively mimicked those in the underlying corporate loans made available by NatWest. The offering circular for the Rose Funding securitisation stated[48] "Each sub-participation to be entered into…..constitutes a limited recourse deposit, such deposit to be repayable **in amounts equal to** (emphasis added) sums received by NatWest (as Lender of Record) under [the relevant loan which is the subject of] the sub-participation….. The entering into of the sub-participations…..does not constitute a purchase or other acquisition or assignment of any interest in the Loans…..Legal and equitable title [to which] will remain with NatWest." The offering circular also highlighted the double credit risk, stating that the sub-participant (Rose Funding No. 1 Limited) had rights solely against NatWest, no rights were enjoyed against the borrowers under the loans and NatWest would not grant any security interest in the loans to mitigate the 'double credit' risk[49].

How and why did the original form of sub-participation agreements change?

In many ways sub-participation became a victim of its own success. The effectiveness of the technique as a means of managing a number of the implications arising from Basel I, whilst

[46] NatWest bank was one of the first European banks to use securitisation as a way to free up capital and improve liquidity of its balance sheet. NatWest's first such transaction, Rose Funding No. 1 Limited, was launched on 29 November 1996. In that transaction, NatWest 'transferred', by way of sub-participation, 300 corporate loans with an aggregate value of approximately $5 billion to Rose Funding No. 1 Limited, a SPV. That transaction was quickly followed by a number of other securitisations using NatWest's 'Rose' securitisation platform and in which NatWest 'transferred' the portfolio of loans to the relevant SPV by way of sub-participation.

[47] For an interesting account of the impact of the Rose Funding transaction, see C. O'Malley, 'Bonds Without Borders: A History of the Eurobond Market' (J. Wiley & Sons) 2014 pp.147-149.

[48] See p.30 (Risk Factors) of the offering circular for Repeat Offering Securitisation Entity Funding No. 1 Limited issued on 29 November 1996 supra n.45.

[49] *ibid*.

also enabling banks to maintain relationships with their prized borrowers, led to it being increasingly used not only in the private secondary loan sale market but also in the developing public CLO securitisation market. It was the latter that, in the mid to late 1990's, started to raise concerns about the additional risks associated with transfers by way of sub-participation. Those concerns were typically included in the 'Risk Factors' section of the relevant offering document[50] and focussed on two issues: (i) double credit risk; and (ii) the lack of control/enforcement rights in respect of the underlying portfolio of loans transferred to the CLO special purpose vehicle issuer[51]. With regard to the former it is interesting to note the risk was not addressed by seeking to structure the sub-participation in such a way that mitigated the credit risk of the Lender of Record[52] but rather by either linking the rating of the bonds issued by the SPV to that of the bank originator/Lender of Record; the rating of NatWest in the case of the 'Rose' securitisation programme[53] or, in a classic CLO securitisation, by imposing both an absolute cap on the aggregate amount of sub-participated loans that could be included in the underlying pool and individual counterparty (Lender of Record) credit exposure limits, linked to the rating of each such counterparty. Initially it was not uncommon for the absolute cap to be set at a figure of between 10% and 15% of the aggregate value of the underlying pool of loans and, with regard to individual counterparty credit exposure limits, those were initially set at circa 25% for the highest (AAA) rated counterparties and reduced, on a sliding scale, through the various investment grade counterparty ratings, to 0% for all sub-investment grade counterparties. The limits have been reduced since the CLO market first developed in Europe and in the current market it is not unusual to see the aggregate cap on all sub-participations set as low as 5%. Individual counterparty risk is now calculated by reference to a 'Bivariate[54] Risk Table' which sets out, on a sliding scale, both the individual counterparty (Lender of Record) credit exposure limit and the aggregate exposure limit to each category of investment grade counterparty. The upper end of the table is typically capped at 20% for counterparties with the highest

[50] The 'Risk Factors' are typically included in the offering circular which may constitute a 'Regulated Prospectus' under local securities regulations.
[51] The set-off rights of the borrower against the Lender of Record, in the event of the latter's insolvency, was also typically identified in the 'Risk Factors'.
[52] As was the case following the Global Financial Crisis, see 'Mitigation of the "double credit" risk' below.
[53] Supra n.45.
[54] Bivariate risk is a reference to the risk arising when an asset is subject to the credit risk of two unconnected parties; the borrower and the Lender of Record in the case of a sub-participation.

(AAA/Aaa) credit rating; 10% for AA/Aa1-3 rated counterparties; and 5% for those rated A/A1-A2. All sub-investment grade rated counterparties continue to be excluded.

Insofar as voting control and enforcement rights over the underlying loan are concerned the risks initially focused on were limited to circumstances where the collateral manager in a typical CLO securitisation purchased sub-participations from a Lender of Record[55], that did not itself retain a portion of the loan, and, therefore, may have limited interest in monitoring the terms of the loan and the continued creditworthiness of the borrower[56]. The Risk Factors included in CLO issues also typically made reference to the lack of privity with the borrower, specifically in the context of the inability of the sub-participant to participate directly in the exercise of any voting rights in connection with the enforcement or waiver of any rights following an Event of Default in the underlying loan. The risk of the Lender of Record potentially having interests which were different from the sub-participant, and not being required to consider the latter in connection with the exercise of its voting rights, was also highlighted[57]. However, although early forms of sub-participation agreements did not typically give the sub-participant any rights to direct the Lender of Record how to exercise its rights over the underlying loan, including how to vote at syndicate meetings or otherwise to participate indirectly in the administration of the loan, most agreements did provide the sub-participant with a level of protection in respect of material issues that might adversely impact the sub-participant by, for example, providing that the Lender of Record may not vote in favour of any amendment, modification or waiver that forgave, postponed or reduced principal or interest payable under the loan or which released any relevant collateral securing repayment of the loan without, to the extent the sub-participant would be affected, the

[55] Typically referred to as the “Selling Institution” in CLO offering documentation.

[56] This is sometimes referred to as the “empty creditor” problem or hypothesis following publication of a series of articles in 2007 and 2008 by Professors Henry Hu and Bernard Black: see H. Hu and B. Black, “Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership” (2007), Journal of Corporate Finance, 347; and “Equity and Debt Decoupling and Empty Voting II: Importance and Extensions” (2008), University of Pennsylvania Law Review 156, 625.

[57] Sub-participations may also be subject to the exercise of “bail in” powers by the relevant EU national regulatory authorities pursuant to the EU Bank Recovery and Resolution Directive (2014/59/EU) or by the Bank of England in the UK pursuant to the Bank Recovery and Resolution (Amendment) (EU Exit) Regulations 2020 (SI 2020/1350). This risk is also now typically highlighted in CLO offering documentation which include sub-participations.

consent of the sub-participant[58]. Some very early forms of sub-participations actually permitted the Lender of Record to continue to manage the loan in accordance with its ordinary business practices, as if it had not entered into the sub-participation[59], however, that soon changed[60] to a requirement that the Lender of Record administer the loan with the same care as it would exercise with regard to similar loans which it continued to hold for its own account.[61] Some early forms of sub-participation agreements sometimes went further and required the lender to consult with the sub-participant before agreeing any amendments or waivers with the borrower but it was very rare to see language requiring the Lender of Record to defer to the sub-participant.

Notwithstanding that the additional risks associated with transfers by way of sub-participation, specifically the 'double credit' risk, limited its use in the public, investment grade rated, CLO securitisation market, it continued to be used as a preferred method of transfer in the private secondary loan market both because of the compelling nature of the commercial and regulatory objectives it achieved, and also because it became increasingly common for borrowers to include restrictions in the terms of primary loan agreements on transfers by way of novation and assignment[62]. Those restrictions did not extend to sub-participation[63].

To what extent has the form of and substance of sub-participation agreements changed?

The form, content and legal effect of sub-participation agreements has been the subject of almost constant change since the technique was originally developed and many of those

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[58] In the Rose Funding securitisation NatWest was not entitled to agree any such waiver or amendment unless it received confirmation from the relevant rating agencies that the Notes would not thereby be downgraded – see Risk Factor 4, p.31 of the Rose Funding offering circular, supra n. 45.

[59] This was the case in the Rose Funding securitisation supra n.45 at p.31 of the Offering Circular issued on 29 November 1996.

[60] The obligation would have been difficult to enforce in any event since it lacks the necessary clarity. It was also typically undercut by broad exclusion of liability language typically included in sub-participation agreements for any acts or omissions, other than gross negligence or wilful default.

[61] *Al-Bank Al Saudi Al-Alaini Limited (trading as Saudi International bank) v Arbuthnot Latham Bank Limited* (C.A. Official Transcripts 1990-1997, 2 May 1991)

[62] See "The development of transfer restrictions and their potential impact on sub-participation" below.

[63] For a more detailed analysis of transfer restrictions included in LMA style Loan Agreements see "The development of transfer restrictions and their potential impact on sub-participation" below.

changes have been made under the auspices of the LMA, in particular, through the development by the LMA of standard form documentation which now dominates the secondary market. That documentation, when taken together with various guides and explanatory notes[64] published by the LMA, reflects a more complex and diverse approach to sub-participation than was intended when the technique was originally developed. The most fundamental changes go to the two issues referred to above, namely control over the management and enforcement of underlying loan and mitigation of the 'double credit' risk.

Voting and control rights over the underlying loan

As already indicated, although the risks associated with lack of voting and control rights over the underlying loan was identified early in the development of both the private secondary loan market and also the public securitisation market, buyers of sub-participations were initially willing to accept relatively benign levels of protection to mitigate their lack of control over the management and enforcement of the underlying loan. However, that began to change as the secondary market increasingly shifted its focus towards distressed loans and specialist debt traders and vulture funds became active buyers. Those sub-participants often focussed on a very different business strategy to extract value from their investment in the underlying loan and, as a consequence, were more likely to seek to identify ways in which the rights of the Lender of Record could be enforced[65]. They were also likely to adopt a more aggressive approach to the enforcement of those rights than that typically taken by traditional bank lenders. Since the mid 1990's institutional investors and other non-bank financial institutions have also increasingly sought opportunities to invest in both the primary and secondary markets[66] and higher risk leveraged finance loans, which provide much higher

[64] Examples include the note published by the LMA, January 2010 (and updated October 2017): 'Funded Participations – Mitigation of Grantor Credit Risk'; The 'Guide to Secondary Loan Market Transactions' published August 2018; and, most recently, a 'Secondary Debt Trading Documentation (Par and Distressed) Users Guide', published January 2021.

[65] A good example of which is a "loan to own" strategy.

[66] LMA Guide to Secondary Loan Market Transactions (published August 2018) p.7. The increased involvement of, non-bank, institutional investors in the primary market, especially in the higher risk (and return) leveraged loan market has also been driven by the increased capital requirements imposed on banks under Basel III since the Global Financial Crisis. That will continue following the delayed implementation of Basel IV in January 2023.

rates of return, have increasingly dominated those markets[67]. In the ten years leading up to the Global Finance Crisis in 2008 the European leveraged loan market grew from €28bn, in 1997 to €391bn in 2007[68] and institutional investors accounted for over 50% of that market[69]. That has now grown to more than two-thirds of primary loan issuance in Europe[70].

The distinction between 'par' and 'distressed' loans traded in the secondary market

There has for some time been a clear distinction in the approach taken on the issue of voting and control rights in respect of loans that are traded by way of sub-participation at or near par and those which are traded as 'distressed'[71] and which typically trade in the secondary loan market at a discount to face value. Buyers of distressed loans have sought greater influence over the day to day administration and control of the underlying loan, in particular, the exercise of enforcement rights. The extent of that influence has steadily increased over the years and the current form of LMA Master Funded Participation Agreement contemplates, in the context of a 'Distressed Trade',[72] extensive 'voting rights' being 'granted' to the sub-participant. However, since it is not legally possible to 'grant' such rights directly to the sub-participant, in the context of a derivative instrument which creates no privity of contract between the sub-participant and the borrower[73], the rights are exercised by the sub-

[67] For an interesting account of the historical development of the European Leveraged loan market see N. Volsey and A. Slocombe (Ed), 'The Loan Book: The Syndicated Loan Market through the credit crisis of 2007-2009 and the Consequences and Challenges for the Future', Loan Market Association (2001) Chapters 2 and 3. For a more up to date analysis of the main characteristics of the European Leveraged Loan market and current volumes of activity, see 'Leveraged Finance: Thematic Note' published by the European Banking Authority, ABE/REP/2020/21.

[68] ibid at p.31.

[69] ibid at p.33. The Global Finance Crisis triggered an immediate collapse in liquidity and general lack of confidence in lending and although that affected all parts of the primary European lending market, given its greater reliance on institutional investors, it was the leveraged loan market which suffered the most dramatic impact. In 2009 primary lending in that market all but collapsed to just over €15bn (supra n.64 at p.87), however, volumes steadily increased from 2010 and by 2017 reached a record high of €221.4bn. See 'Leveraged Finance: Thematic Report' published by the EBA, supra n.64 at p.7. The increased dominance of institutional investors has, in part, been due to the more stringent capital requirements imposed on banks under Basel III following the Global Financial Crisis, supra n.4..

[70] ibid.

[71] These are loans which are unlikely to be repaid in full because the borrower is in serious financial difficulty, possibly already in a form of insolvency process.

[72] defined in the LMA Standard Terms and Conditions (29 October 2018) simply as "*one designated as a distressed trade transaction by the buyer and seller ….*"

[73] Although it can be questioned whether the 'no privity' concept has truly been maintained. See "Does elevation change the legal characterisation of sub-participation?" below.

participant via the Lender of Record. The direction and control exercised by the sub-participant takes place behind the curtain, so to speak, in an independent contract between the Lender of Record and the sub-participant to which the borrower is not party and typically has no knowledge of. An extreme version of the approach can be found in clause 6.2 of the current LMA Master Funded Participation Agreement[74] which states that, where voting rights are granted to the sub-participant, the Lender of Record *"is not able to exercise or refrain from exercising* ***any*** *of its rights under the [underlying loan agreement] ……., agree to* ***any*** *variation or waiver of the [terms of the underlying loan agreement] ….. or perform* ***any*** *acts thereunder without the consent of the [sub-participant]"*[75]. Conversely that very same LMA document makes clear that, if no voting rights are specified, the Lender of Record may exercise or refrain from exercising **all** its rights under the underlying loan against the borrower "as it sees fit" without **any** [emphasis added] regard to the interests of the sub-participant[76]. These two extreme positions governing the exercise, or not, as the case may be, directly and/or indirectly, of voting rights in respect of the underlying loan are a graphic example of the way in which sub-participation agreements have changed and, perhaps more importantly in the context of the current analysis, the extent to which the rights and obligations under one agreement may differ fundamentally from those under another. And although the LMA precedent document contemplates voting rights being granted only in respect of a distressed trade its Users Guide[77] recognises that such rights may also be granted where the transaction is a par trade[78].

Additional complexity where there are multiple sub-participants with indirect voting control

It has been suggested that the granting of voting rights to a sub-participant is likely to be more complex where the sub-participation is less than 100 per cent of the Lender of Record's exposure[79] i.e. where the Lender of Record retains an economic interest in the loan and/or in

[74] LMA Master Funded Participation Agreement (PAR/DISTRESSED) dated 29 October 2018.
[75] See Section 8.3(h) of the LMA User Guide (18 December 2019).
[76] Supra n. 64 [Cl. 6.2 (i)]
[77] LMA Secondary Debt Trading Documentation (Par and Distressed) Users Guide published 1 January 2021.
[78] ibid p.93 where the LMA cautions users that the precedent document "will…..need to be amended accordingly".
[79] *A. Damianova*, *'The legal cost of loan participations post financial crisis' BJ1BFL [2011] 23, at p.24*

cases where that lender has granted multiple sub-participations to different parties who may have different commercial objectives. Ignoring the borrower relationship challenges this may present for the Lender of Record, which we will turn to later, such complexities should be relatively simple to resolve by the incorporation, within the terms of the sub-participation agreement, of clauses similar to those included in syndicated loan agreements that address the management of the loan via the role of the Agent bank thereby enabling the various sub-participants, and potentially the Lender of Record if it retains an economic interest in the loan, to exercise voting rights by reference to the proportion of the aggregate exposure they hold in the underlying loan[80] together with an obligation, on the part of the Lender of Record, to exercise those rights on behalf of all sub-participants[81]. Appropriate voting thresholds would also need to be established and, as is the case in the primary syndicated loan market, those thresholds may differ depending on the materiality of the issue upon which the sub-participants are required to 'vote'. Those thresholds may range from the typical $66^2/_3\%$ required for 'Majority Bank' consent type matters, to a 'Super Majority', typically set at 75%, and perhaps unanimity (100%) for a small number of very material issues, for example, reducing principal and/or interest or extending the term of the loan.

The 'granting' of voting and control rights in the context of a derivative instrument

The 'granting' of voting rights to a sub-participant, as contemplated in the current LMA Master Funded Participation Agreement[82], potentially creates a more significant problem, however, in the context of the ongoing relationship between the Lender of Record and the Borrower. The Lender of Record may continue to 'enjoy' privity of contract with the borrower but where voting rights have been 'granted' to the sub-participant[s] there is no substance to that privity, it is commercially empty. This places both the Lender of Record and the borrower in a potentially difficult position. The Lender of Record is required at all times to act in

[80] Assuming the loan has been fully sub-participated or the value of the sub-participated portion of the loan, and that portion which the Lender of Record continues to hold, equal 100% of the total commitments of the Lender of Record.
[81] In the case of a syndicated loan those rights would be exercised by the Lender of Record via the Agent Bank appointed in respect of the underlying loan.
[82] Supra n.[73].

accordance with the instructions of the sub-participant[83] in its dealings with the borrower, however, since sub-participations are typically not disclosed to the borrower,[84] those instructions will be implemented in circumstances where the borrower is unaware the Lender of Record, possibly a relationship lender, is acting under the direction and control of one or more third parties. Such an arrangement mirrors many of the elements of a principal/undisclosed agent relationship, a construction which was applied to various English law governed sub-participation agreements by the US Court of Appeals, Second Circuit, in *Commercial Bank of Kuwait v Rafidain Bank*[85]. In that case the court held that the Lenders of Record (the primary syndicate lenders) had entered into the underlying loans with the Iraqi banks (as borrowers) as undisclosed agents of the sub-participants and under English law an undisclosed principal (the sub-participant) has standing to bring an action directly against the borrower. The court found it "hard to believe the Iraqi Banks [the borrowers] did not know that the [underlying] loans were the subject of [sub-]participation agreements and that they, as borrowers, were potentially liable to the [sub-]participants. Such loan [sub-]participations are common practice"[86]. The judgement of the court makes no reference to terms typically included in English law governed sub-participation agreements, which expressly exclude the Lender of Record acting as agent, fiduciary, trustee or custodian of the sub-participant, nor does the court appear to have considered the significance of the underlying loans being entered into some time before the sub-participations were executed. There are occasions where a Lender of Record will enter into a loan intending silently to 'syndicate' its commitment by way of sub-participation contemporaneously upon the loan being drawn down by the borrower. In such cases, primarily to mitigate the capital carrying costs of the loan immediately upon the loan being executed, it may enter into one or more risk sub-participation agreements at the time the loan agreement is executed and those risk sub-participations will convert into funded sub-participations immediately upon drawdown by the borrower[87]. Such an arrangement is more akin to an undisclosed agency, especially in

[83] Or the 'Majority' thereof if the Lender of Record has entered into sub-participations with more than one entity in the same underlying loan.
[84] This was historically the case although, for reasons explained later, borrowers are increasingly requiring sub-participations to be disclosed, see "Restrictions on sub-participation" below.
[85] *Commercial Bank of Kuwait v Rafidain Bank and Central Bank of Iraq* 15 F 3d 238 *(*2nd Cir, 1994*)*
[86] ibid at 243.
[87] The LMA Risk to Funded Participation (PAR) agreement (published 29 October 2018) is an example of such an approach.

circumstances where the Lender of Record consults with, and takes instructions from, the sub-participants in advance of the underlying loan agreement being executed. However, no such arrangement was in place in the Commercial Bank of Kuwait case; the underlying loans were entered into (and drawn down by the borrower) some time before the sub-participations were executed. The Privy Council in a later and currently the leading English law case on sub-participation agreements[88] made no reference to the decision of the US Court of Appeal in its judgment and its construction is unlikely to be followed in cases where the sub-participation agreement is based on current LMA style documentation[89].

Failure to act upon the instructions of the sub-participant

Failure by the Lender of Record to comply with the voting/control provisions included in a sub-participation agreement and act on the instructions of the sub-participant will be a breach of contract giving rise to a claim in damages by the sub-participant. However, sub-participants have increasingly recognised that a claim in damages alone will often be insufficient to protect their economic interest in the underlying loan and may seek to mitigate that risk by including a provision in the sub-participation agreement stating that any unapproved changes will not be binding on the sub-participant[90]. The drafting of such provisions requires careful consideration to ensure the sub-participation continues to 'mimic' the original unamended terms of the underlying loan. This may be problematic in circumstances where the unapproved changes relate to key economic terms and, if the sub-participation agreement is incapable of operating independently of those changes, the failure to act upon the binding instructions of the sub-participant might be drafted to trigger an immediate repayment obligation by the Lender of Record of the outstanding amount of the sub-participation, together with a claim in damages for any additional loss suffered by the sub-participant.

[88] *Lloyds TSB Bank plc v Clarke and another* supra n 27.

[89] All current forms of LMA sub-participation agreements, including the LMA Risk to Funded Participation (PAR) Agreement (*supra* n.86), expressly exclude the Lender of Record acting as agent, fiduciary, trustee or custodian of the sub-participant. See, for example, clause 6.1(d) LMA Master Funded Participation Agreement (PAR/DISTRESSED), (published 29 October 2018).

[90] *Supra* no.77 at p.24.

Elevation

Another significant development that has potentially far reaching effect on the nature and legal effect of sub-participation is the inclusion of a provision known as 'elevation'. As its name suggests, this mechanism entitles the sub-participant[91] to require its position to be elevated to that of 'Lender' as defined in the underlying loan agreement. Alternatively, if the sub-participant is not able to act in that capacity, because, for example, the underlying loan contains transfer restrictions which extend to the sub-participant, the clause enables the sub-participant to request the sub-participated portion of the underlying loan be transferred to another party[92], which is not caught by the restrictions, and which will become a Lender, with the intention that the sub-participant then enters into a new sub-participation with that party in order to maintain its economic interest[93].

The elevation mechanism included in the current LMA Master Funder Participation Agreement is expressed to be available "on request" by either the sub-participant or the Lender of Record. The relevant clause[94] provides that "*subject to the terms ………. of the [underlying loan agreement]*" either party can request that the sub-participant's position to that of 'Lender' under the underlying loan. Upon any such request both the Lender of Record and the sub-participant are required to "use its commercially reasonable efforts to, as soon as reasonably practicable, execute any documents as the other party may reasonably request to ensure the sub-participant becomes a Lender [of Record] with regard to the relevant portion of the underlying loan that is the subject of the sub-participation"[95]. The proviso limiting elevation by reference to terms in the underlying loan agreement is, in part, recognition that one of the reasons why sub-participation is frequently used as the method of transfer is because it was not, until relatively recently, caught by the transfer restrictions typically included in primary loan agreements, including the need to obtain borrower consent.

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[91] The right is also conferred on the Lender of Record.
[92] Referred to as the "Buyer" in LMA precedent documents.
[93] Such a transfer to a third party would thereby mitigate the sub-participant's double credit risk on the original Lender of Record by transferring that risk to the third party "Buyer".
[94] See Clause 19 of the LMA Master Funded Participation Agreement/PAR/DISTRESSED (published 29 October 2018).
[95] ibid.

As we shall see later[96] this is now changing. Until relatively recently Lender transfer restrictions included in primary loan documentation focussed on transfers made by way of novation and assignment[97] since it is only a transfer by one of those methods that enable a party to become, and enjoy the rights of, a 'Lender' as defined under those forms of agreement. However, some of the more recent changes made to those transfer restrictions has resulted in transfers by way of sub-participation, which include an elevation mechanism, being of increasing concern to borrowers. That is because LMA primary loan agreements now typically disapply all borrower consent requirements for transfers by way of novation or assignment[98] for so long as there is an Event of Default outstanding under the underlying loan. The definition of an 'Event of Default' for these purposes is very broad and captures technical as well as credit related matters[99]. This exposes borrowers to the risk that a previously restricted sub-participant will be elevated to a Lender under the relevant loan, and be able to exercise all the associated rights[100], immediately upon any Event of Default arising[101]. A borrower might be concerned at the prospect of its Lender[s] changing at such a time, particularly if the Lender of Record is a relationship lender or in circumstances where it views the Event of Default as a temporary problem and not related to a material deterioration in the quality of the credit. Experiences during the Global Finance Crisis and, more recently, the Covid-19 pandemic, demonstrate the lender/borrower relationship does matter: "The banks that were most tolerant during any downturn in business, or most willing to refinance during the credit crisis of 2007-2009, have been found to be those with whom [borrowers] had close and productive relationships"[102]. Consequently, borrowers have increasingly sought to limit the Events of Default that obviate the need for borrower consent in respect of transfers by way of novation and assignment to 'Material Events of Default',

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[96] See 'Transfer restrictions on sub-participation' below.
[97] Ibid.
[98] It is only such methods of transfer that will enable the sub-participant to become a 'Lender' as defined under the relevant loan agreement.
[99] See, for example, Clause 24.4 of the LMA standard form Multicurrency Term and Revolving Facilities Agreement published on 25 May 2021.
[100] In the event the elevation triggers a transfer by way of novation it will also transfer any obligations of the Lender of Record, including the obligations to lend. This will be of particular concern to the borrower if the underlying loan includes a revolving facility and/or further drawdowns are available under a term loan facility.
[101] The Event of Default must also be "continuing" when the elevation mechanism is activated.
[102] Martin O'Donovan, 'The Borrower/Lender Relationship: the Borrower Perspective' in 'The Loan Book', supra n.66 at p111.

which are often limited to non-payment, insolvency related events and, possibly, breach of material financial covenants.

Additional risks posed by elevation

The risks associated with the elevation mechanism are heightened for a borrower in circumstances where a number of sub-participations have been entered into, of which the borrower is typically unaware, and which are effectively 'primed' by that mechanism pending the occurrence of any Event of Default. Those potential risks are not only limited to elevation of the sub-participations in place at that time an Event of Default is triggered (and is continuing). This is because once a sub-participant is elevated, and thereby becomes a Lender, as defined under the relevant underlying loan, no further borrower consent restrictions will apply to the ability of that new Lender to acquire further interests in the loan, either by way of novation or assignment. There is typically no requirement to obtain borrower consent in respect of transfers to "Existing Lenders" which the sub-participant will become following its elevation to the status of 'Lender'. Consequently one or more relatively small (by value) sub-participations will, following elevation, expose a borrower to unrestricted transfers by way of novation or assignment to those sub-participants and potentially enable them to acquire either a negative control 'blocking' position[103] or direct voting control[104] over the entire underlying loan.[105]

Does elevation change the legal characterisation of sub-participation?

Notwithstanding the right of either party to request elevation is subject to the terms of the underlying loan, which includes any transfer restrictions, the latter are not typically absolute, consequently, the right to trigger elevation is a contingent, future right granted to the sub-participant[106] immediately upon the sub-participation being entered into. This right to

[103] Typically set at any holding (in aggregate) exceeding $33^1/_3$% of the total outstanding commitments in LMA precedent primary loan agreements, which enables a party to block a "Majority Lender" decision.
[104] Typically set at $66^1/_3$% of the total outstanding commitments in LMA form primary where the sub-participant is able to exercise voting control in respect of "Majority Lender" matters.
[105] Clause 26.1 and 26.2 of the LMA Multicurrency and Revolving Facilities Agreement (published 28 May 2021).
[106] and the Lender of Record.

require a legal or equitable transfer of the underlying loan fundamentally changes the nature of sub-participation, which is no longer intended always to operate as a purely derivative arrangement, indeed, it is contemplated the sub-participant may ultimately enjoy an ownership interest in the underlying loan and privity with the borrower.

The LMA appears to agree the inclusion of the elevation mechanism changes the nature of sub-participation and is designed to transfer an ownership interest in the underlying loan: "the [sub-]participant's right to request a transfer of the [underlying] loan….[by triggering the elevation mechanism], together with the [Lender of Record's]….representation that it owns the [underlying] loan and covenant not to transfer or encumber the loan, other than in favour of the [sub-]participant, illustrate the LMA [form of sub-]participation is designed to transfer an ownership interest in the [underlying] loan to the [sub-]participant after the effectiveness of the [sub-]participation"[107].

The triggering of the LMA style elevation mechanism does not automatically convert the sub-participation into a transfer by way of novation or assignment immediately upon the relevant contingency being satisfied, but rather it terminates[108] the sub-participation agreement and replaces it with a direct legal or equitable interest in the relevant portion of the underlying loan[109]. This is achieved by the execution of either a 'Bilateral Termination and Transfer Agreement'[110], in circumstances where the sub-participant is to become a 'Lender' in respect of the portion of the underlying loan, or a 'Multilateral Termination and Transfer Agreement'[111] where it is proposed that a third party (the 'Buyer') will become such a Lender. The former will typically be entered into when there are no restrictions in the underlying loan

[107] Letter dated 22 July 2011 from Clare Dawson, Managing Director, LMA to David A. Starwick, Secretary, Commodity Futures Trading Commission and Elizabeth M. Murphy, Secretary, Securities and Exchange Commission.
[108] The sub-participation agreement may not be terminated completely. To the extent either the Lender of Record or the sub-participant have outstanding obligations and liabilities both the LMA Bilateral and Multilateral Termination and Transfer Agreement contemplate they will survive. See Clause 2.3 of both agreements n.108 below.
[109] The agreement by the sub-participant to release the Lender of Record from its obligations under the sub-participation is the consideration for the transfer, by way of novation, of the relevant portion in the underlying loan to the sub-participant the LMA Bilateral Termination and Transfer Agreement (Bank Debt/Novation) 14 May 2012 and the LMA Multilateral Termination and Transfer Agreement (Bank Debt/Novation) 3 March 2014.
[110] LMA Bilateral Termination and Transfer Agreement (Bank Debt/Novation) published 14 May 2012
[111] LMA Multilateral Termination and Transfer Agreement (Bank Debt/Novation) published 3 March 2014

preventing the sub-participant becoming a Lender or, such restrictions no longer apply, because, for example, an Event of Default has occurred,[112] and the latter in circumstances where such restrictions continue to prevent the sub-participant becoming a Lender[113]. In the event a Multilateral Termination and Transfer is entered into the sub-participant and the Buyer will also enter into a new sub-participation agreement pursuant to which the sub-participant will maintain its economic interest in the underlying loan. That new agreement may be drafted on very different terms than the original (now terminated) sub-participation agreement and may, for example, give the sub-participant greater indirect voting and control rights over the underlying loan[114]. This may be the case even where the elevation is at the request of the Lender of Record[115]. Somewhat surprisingly both the Bilateral and Multilateral form of termination and transfer agreement developed by the LMA provide for the transfer to be made only by way of novation, which transfers not only the rights of the Lender of Record in the underlying loan but also any outstanding obligations, and may, therefore, be of particular concern to the borrower if further drawdowns are available to it.[116] No reference is made in either form of termination agreement to a potential transfer by way of assignment, which would satisfy the requirements of the elevation mechanism, and enable the sub-participant (or Buyer in the case of a Multilateral transfer) to become a Lender as defined in the underlying loan. Novation of the underlying loan is achieved by the delivery of an executed Transfer Certificate, as contemplated in the underlying loan agreement, simultaneously with the execution of either a Bilateral or Multilateral Termination and Transfer Agreement so, ultimately, the derivative interest of the sub-participant is replaced by either a direct contractual relationship with the borrower or, in the case of a Multilateral transfer, the Buyer.

An additional potential objective of the elevation mechanism is to mitigate double credit risk. A good example of how this is achieved occurs where the sub-participant requires elevation

[112] And is continuing at the time the elevation is triggered by either the Lender of Record or the sub-participant, supra n.90.
[113] The current version of the LMA Master Funded Participation Agreement (Par/Distressed) (published 29 October 2018) requires the Lender of Record to use its 'reasonable endeavours' to assist the sub-participant to satisfy any conditions to transfer, including obtaining borrower consent, see clause 19.2.
[114] See 'Voting and control rights over the underlying loan' above.
[115] See Clause 19.3.
[116] See clause 2.1 of both forms of agreement, supra n 108.

to be available in circumstances where the credit quality of the Lender of Record becomes an issue, for example, by linking elevation to a rating downgrade of that party. In the event the restrictions typically included in LMA primary loan documents prevent the sub-participant becoming a Lender at that time, the parties may agree the sub-participant can identify an eligible transferee, which is not subject to the restrictions, another existing 'Lender', for example, or another bank, to which the relevant loan (or portion thereof) will be transferred, with a view to the sub-participant entering into a new sub-participation agreement with that entity, thereby transferring its 'double credit' risk from the Lender of Record to the new Lender. A potential concern with such an approach is that if elevation occurs shortly before the insolvency of the original Lender of Record it may be set aside as a preference; the Lender of Record has put the sub-participant into a more favourable position than its other unsecured creditors[117]. Notwithstanding the elevation mechanism included in LMA style agreements is not drafted in such a way that it converts the sub-participation into a novation or an assignment, rather it provides a mechanism for the existing sub-participation agreement to be terminated[118] and replaced by a separate agreement, between the nominated transferee and the sub-participant, it would still trigger potential clawback risk if the transfer occurs within six months of the Lender of Record going into insolvency[119]. This is because, in order to complete the elevation mechanism, the Lender of Record is required to execute an appropriate transfer certificate, in favour of the new 'Lender' (either the sub-participant or the third party 'Buyer'), thereby putting the sub-participant in a potentially more favourable position than other unsecured creditors of the Lender of Record.

The ability to consummate a direct contractual relationship or ownership interest, as the LMA calls it, with the borrower may or may not be subject to contingencies but, either way, a sub-participation agreement which includes such a mechanism is fundamentally different, from both a legal and commercial perspective, from that originally developed in the secondary market. As originally conceived sub-participation was never intended to transfer any ownership interest in the loan to the sub-participant. The wording of the agreement typically

[117] Insolvency Act 1986, s.239.
[118] Interestingly the LMA Master Funded Participation Agreement does not contemplate the existing sub-participation terminating in its entirety. Any accrued rights which have arisen prior to the effective date of the elevation remain in full force and effect – see Clause 19.5.
[119] S.239 Insolvency Act 1986. The period is extended to two years for transactions with connected persons.

stated that quite explicitly[120] and the importance of such wording was highlighted by the Privy Counsel in the leading English Law case characterising English law governed sub-participations[121].

Elevation raises some important questions about the fundamental nature of LMA style sub-participation agreements and the potential risks they present for borrowers, particularly in the context of any future drawdowns that might be available under the loan and also in respect of its ongoing management, control and enforcement, especially following an Event of Default.

Mitigation of the "double credit" risk

As previously stated, notwithstanding double credit risk was identified as a material additional risk very early in the development of a secondary market, it did not prevent sub-participation becoming one of the most popular methods of transfer used in that market[122]. Since Lenders of Record were, initially, typically regulated banks the market regarded the risk as largely theoretical and the Bank of England dropped its "best practice" requirement that the risk should be mitigated by the sub-participant taking a mortgage or charge over the underlying loan[123]. The risk was also identified in offering documentation[124] in the public securitisation market and there it did result in limitations being imposed, either by linking the rating of the bonds issued to the credit ratings of the bank originator, Nat West in the case of securitisations under the Rose Funding programme,[125] or, in the CLO market, by imposing limits on the aggregate value of all sub-participated assets that could be included in the portfolio and also on individual counterparty exposure in order to achieve the desired

[120] See "The regulator gave early approval to sub-participation as an effective method of 'transfer' for bank regulatory purposes' above.
[121] Their Lordships were of the view "that it would be hard for the draftsman to have made it clearer [that the sub-participation created] a debtor-creditor relationship without giving the sub-participant any interest in the underlying loan", supra n.27 at p.997.
[122] M. Allen, 'Asset Sales – an analysis of risk for buyers and sellers', supra n.12.
[123] Supra n.25: see also S. Abrahams and M. Reed, 'Bank of England Notice (BSD/1992/3) to Amend the Bank's Notice on Loan Transfers and Securitisation (BSD/1989/1)' [1992] 7 Journal of International Banking Law 129.
[124] It was typically included in the 'Risk Factors' section of the offering circular for the relevant Notes or bonds.
[125] Supra n.45.

investment grade credit ratings for the various tranches of the notes being issued[126]. However, those limitations were considered to be manageable and did not result in changes to the form or substance of sub-participation agreements to mitigate the risk, at least not until the 2007/2008 Global Financial Crisis (the "GFC"). The GFC triggered a fundamental reappraisal of the risk and as early as January 2009 the LMA published a discussion paper entitled "Funded Participations – Mitigation of Grantor Credit Risk" in which it sought market feedback on the various options available. That paper led to the publication of a more formal paper by the LMA in January 2010[127] setting out six possible options to address the risk. Those options were: (i) a declaration of trust over the underlying loan and proceeds; (ii) the grant of security over the underlying loan and proceeds; (iii) credit support; (iv) transfer of the underlying Loan by way of novation to a bankruptcy remote SPV affiliate of the Lender of Record which would, in turn, enter into a new sub-participation agreement with the sub-participant; (v) elevation of the sub-participation to a transfer by way of novation or assignment to the sub-participant; and (vi) entering into a participation agreement under New York law.

Given the primary aim of the LMA is to encourage liquidity in the primary and secondary loan markets it is not surprising the introduction to its paper makes clear the LMA is not seeking "to prescribe mitigation techniques for [LMA] members to adopt"[128] and the conclusion notes "all the options set out in this paper have potential issues associated with them"[129]. Those "issues" include potentially undermining some of the key characteristics of the classic English law governed sub-participation which resulted in the technique becoming such a popular method of transfer in the secondary market, and a tightening of the transfer restrictions included in primary loan agreements, both of which have the potential to adversely impact liquidity in the loan market.

[126] These limits are typically calculated by reference to a 'Bivariate Risk Table', see 'How and why did the original form of sub-participation agreements change' above.
[127] LMA paper, 'Funded Participations – Mitigation of Grantor Credit Risk' (published in January 2010 and subsequently updated in October 2017).
[128] ibid p.1.
[129] ibid p.8.

A declaration of trust would separate legal and beneficial ownership in the underlying loan and proceeds and create an immediate proprietary interest in favour of the sub-participant and although the Lender of Record would continue to hold legal title and act as 'Lender of Record'[130], there are circumstances where the sub-participant would be able to enforce directly against the borrower by use of the Vandepitte procedure[131]. Such a procedure would permit the sub-participant (as the beneficiary of a trust) to sue the borrower in its own name joining the Lender of Record (in its capacity as trustee) as a defendant, if it refuses to enforce the loan, thereby undermining a key legal and commercial driver of the technique[132]. There are also circumstances where the sub-participant may be able to wind up the trust and require the trustee to transfer the trust property (the underlying loan) to it. The Lender of Record would no longer enjoy full proprietary ownership of the loan and would act in a fiduciary capacity in its relationship with the sub-participant. The LMA paper highlights potential problems that might arise in the event the Lender of Record goes into insolvency, namely that the trustee would then be acting through its liquidator or administrator who would have no interest enforcing the sub-participants claim[133]. There is also a potential risk the liquidator might disclaim the underlying loan as onerous property (i.e. an unprofitable contract)[134]. To mitigate the former risk the LMA suggests a provision be included to replace the insolvent trustee and granting an irrevocable power of attorney in favour of the sub-participant to secure the trust obligations of the Lender of Record, which would enable the sub-participant to exercise the trustees' powers in respect of the underlying loan in the name of the trustee/Lender of Record[135]. Potential problems that might arise under s.178 of the Insolvency Act should also be capable of being mitigated, by the Lender of Record retaining a small commitment in the underlying loan, or by the parties agreeing that the Lender of Record will act as collection agent for the sub-participant and be entitled to payment of a fee, when

[130] LMA standard form primary loan documentation typically restrict a party becoming a Lender of Record only to transfers by way of assignment and novation.

[131] *Vandepitte v Preferred Accident Insurance Corp of New York* [1933] A.C. 70; allowing a beneficiary to sue directly by joining the trustee. See also *Explora Group Plc v Hesco Bastion* [2005] EWCA Civ 646 at [108] and also the judgment of *Rix L.J. in Barbados Trust v Bank of Zambia* [2007] EWCA (Civ) 148. Appropriate drafting of the Sub-Participation agreement should, however, prevent the use of the Vandepitte principle.

[132] However, see *Don King Productions Inc. v Warren* [2000] Ch. 291 at 321 and 355 in which Lightman J. and, in the Court of Appeal, Morritt L.J. suggested a court would be hesitant in permitting use of the Vanderpitte principle in a commercial context.

[133] Supra n.126 at p.3.

[134] Under the Insolvency Act 1986, s.178.

[135] Supra n.126 at p.3(3).

it recovers amounts from the borrower, so that, again, the liquidator will collect an asset (the fee) by taking steps to recover the debt.

The combination of features suggested by the LMA in respect of a declaration of trust over the loan and proceeds would fundamentally change the nature of sub-participation and the LMA rightly cautions their use would encourage borrowers to apply the same transfer restrictions to sub-participations that apply to transfers by way of novation and assignment, thereby undermining one of its key commercial objectives.

An alternative option, not mentioned in the LMA paper, which should be less offensive to borrowers and reduce the likelihood of them seeking to include additional transfer restrictions in primary loan agreements[136], is a proceeds assignment which, unlike statutory and equitable assignment, does not involve the assignment of any rights against the borrower. Instead it involves a declaration of trust (hence it is often referred to as a proceeds trust) pursuant to which the sub-participant obtains a proprietary interest in a contingent right, namely a right to the fruits of the underlying loan; the payments of principal and interest once made by the borrower. The sub-participant does not obtain any right of action against the borrower but payments, once made by the borrower, are impressed with the trust immediately upon receipt by the Lender of Record. Those receipts will not form part of the insolvent estate of the Lender and, therefore, will not be available to its general creditors. The right of the sub-participant is to receive the actual funds paid by the borrower to the Lender of Record. In contrast to the position in a classic sub-participation[137], which requires the Lender to pay a sum **equivalent[138]** to that received from the borrower, the obligation under a proceeds assignment is to pay the funds, in whole or in part, depending on whether the sub-participation is for the entire commitment of the Lender of Record, **actually received** by the Lender. Since a proceeds assignment has no impact on the underlying loan, the trust

[136] This option should also mitigate the counterparty risk limitations imposed on sub-participations in the CLO market.
[137] And identified by Lord Hoffman in the *Lloyds TSB Bank* case as the key operative provision, supra n.27 at [25].
[138] It is interesting to note that in the event a Lender of Record receives "Non-Cash Distributions" basically any non-cash asset or right, from the borrower in satisfaction of any payment obligation owing by the borrower, the LMA precedent documentation requires the Lender of Record to transfer to the sub-participant [the relevant portion of] that Non-Cash Distribution, supra n.73 clause 3.3.

only extends to payments once made by the borrower and received by the Lender, no notice is required to be given to the borrower, therefore, a sub-participation including such a feature would not need to be disclosed to the borrower[139] and should not result in borrowers seeking to apply restrictions against its use[140].

No particular formalities are required for a proceeds assignment, however, care must be taken in drafting its terms to evidence the intention that the Lender of Record holds the monies recovered from the borrower on trust for the sub-participant, immediately upon receipt, and for those monies to be appropriately segregated in order to avoid difficulties that can arise in tracing trust funds through commingled bank accounts. This difficulty could be addressed, either by imposing an obligation on the Lender of Record immediately to pay monies received from the borrower into a separate account, for the benefit of the sub-participant, or by the creation of a trust over the commingled account into which the monies are received. In the latter case, the sub-participant would be a beneficiary of all amounts standing to the credit of the account which are referrable to payments made by the borrower and the trust documentation should ensure those amounts are identified with sufficient 'certainty'[141] in order to establish the subject matter of the trust and the sub-participants beneficial entitlement to them. The Lender of Record would be the beneficiary of all other amounts standing to the credit of the account not beneficially belonging to the sub-participant. This type of arrangement is commonly used in investment grade rated securitisation transactions and, provided the relevant payments from the borrower which are credited to the account are capable of being clearly identified (which should not be problematic), should protect the sub-participant's beneficial interest in those payments against the insolvency risk of the Lender.

A further potential problem with this proposal is that the sub-participant will not be able to bring a claim against the borrower, because there has been no assignment of the Lender's

[139] Unless such disclosure is required by the loan agreement, which is not typically the case.
[140] See 'The development of transfer restrictions and their potential impact on sub-participation', below. Transfer restrictions on assignment included in primary market agreements do not typically cover a proceeds assignment.
[141] In order to satisfy one of the "three certainties" required to declare a trust as famously stated by Lord Langdale M.R. in *Knight v Knight* (1840) 49 E.R. 58 (affd. as *Knight v Broughton* (1844) 8. E.R. 1195).

right of action against the borrower, and, following the insolvency of the Lender, its liquidator would have no interest in bringing an action to enforce the debt (assuming the Lender has retained no economic interest in the underlying loan). There is also a risk the liquidator might 'disclaim' the underlying loan as onerous property under s.178 Insolvency Act 1986. As previously indicated, such a problem should be relatively easy to address, either by the Lender of Record agreeing to retain a small part of the underlying loan or by it agreeing to act as collection agent for the sub-participant for which it would be paid a fee in respect of payments recovered from the borrower. In both cases the liquidator would acquire an asset which would be available for distribution to the Lender's general creditors.

Reference has previously been made to the second option proposed by the LMA[142] and, notwithstanding the heightened focus on counterparty risk in the aftermath of the Global Financial Crisis, there continues to be little enthusiasm for Lenders of Record to grant a registrable security interest to mitigate their own credit risk[143]. Little need be said about the proposal to transfer the underlying loan to a bankruptcy remote SPV which is an affiliate of the Lender of Record[144]. The significant potential tax consequences are highlighted in the LMA paper[145] and such an approach is likely adversely to impact the relationship between the Lender of Record and the borrower which will be made aware of the transfer of the loan to an SPV, set up purely for the purpose of protecting a sub-participant against the perceived credit risk of the Lender of Record. Potential drawbacks with 'elevation' have been considered earlier and some of those are recognised in the LMA paper, particularly with regard to transfer restrictions in the underlying loan agreement that might prevent completion of the elevation mechanism. The LMA paper also highlights the practical problem of completing the necessary transfer documentation[146] in circumstances where the Lender of Record is in financial difficulty[147] and concludes it would "not be a robust means of mitigating

[142] See above: "Additional risks associated with transfers by way of sub-participation were recognised early and did not undermine its use, above."
[143] Supra n. 125, Option 2, para 8 at p.6.
[144] And therefore not typically subject to transfer restrictions included in primary market loan agreements.
[145] Supra n.126 at p.6.
[146] The relevant "transfer agreement" in the case of a transfer by way of novation or "assignment agreement" in the case of transfers by way of assignment, as contemplated in the 'Changes to the Lenders' section of standard form LMA primary loan agreements.
[147] Somewhat surprisingly, the LMA paper makes no reference to the risk of preference clawback, supra n.116.

[Lender of Record] risk in all circumstances[148]. In a similar vein, entering into a participation agreement under New York law is considered by the LMA to be problematic both because of the uncertainty in the way in which New York law governed participation should be construed under English law and because of issues that would arise if the agreement was construed as either an equitable assignment of the Lender of Record's rights under the loan or as a declaration of trust over those rights[149]. In the context of seeking to promote liquidity in the secondary market it would also potentially inhibit that by creating unnecessary conflict of laws uncertainty and, at a more practical level, require additional legal advice to be obtained by the parties. The counterparty risk mitigation sought by a participation governed by New York law could be achieved under English law by a declaration of trust and/or a proceeds assignment[150].

The LMA recognises "none of the options discussed [in the paper] is free from drawbacks"[151] and accordingly it is not making "any recommendations as to whether any particular mitigation technique is appropriate for any particular transaction or at all.[152] The LMA cautions that should a market consensus emerge, its approach may change but, to date, there has been no such consensus[153] and the heightened focus on double credit/counterparty risk that arose in the aftermath of the Global Financial Crisis has lessened in recent years[154]. However, this issue is likely to return when the market faces another downturn and it continues to imposed limits in the CLO market. The risks should be capable of being appropriately mitigated by the inclusion of a proceeds assignment/benefits trust, as described above, which would not undermine the key commercial characteristics of sub-participation nor result in borrower seeking to impose further restrictions on its use.

[148] Supra n.126 at p.7.
[149] LMA Paper 'Option 6, para 2 pp 7-8 supra n.126. For an interesting comparison between New York law and English law governed agreements see R. Gray and S. Mehta, 'Loan Participations: US and UK compared', IFLR, October 2009, 42.
[150] See the analysis above on the potential use of an English law governed proceeds assignment.
[151] Supra n.[126] p.1.
[152] ibid.
[153] The LMA has made no further recommendations on mitigation of double credit risk.
[154] The tax issues arising from the various options are also highlighted in the LMA paper but not analysed in detail. For a detailed analysis of some of the potential tax implications see A. Blackmore and O. Iliffe, 'Sub-Participations, Taxation and the Mitigation of Lender Credit Risk, [2011] 6 JIBFL 349.

The development of transfer restrictions and their potential impact on sub-participation

Restrictions on the ability of the Lender of Record to transfer all or part of its exposure under a loan have existed since the inception of the primary syndicated loan market. Those restrictions focussed on transfers which included a proprietary interest in the loan; initially transfers by way of assignment and, following the introduction of the "standing offer" technique in primary loan agreements, transfer by way of novation[155]. Such restrictions were not typically drafted in such a way that prevented Lenders of Record undertaking other methods of transfer, which had substantially the same economic effect, for example, a transfer by way of trust, which might include a 'benefits' trust over the rights of the Lender of Record against the borrower and/or a proceeds trust or proceeds assignment, which extends only to the "fruits" of the contract, namely principal and interest payments once they are received by the Lender of Record, and certainly not sub-participation. Indeed, this is one of the reasons why sub-participation became such a popular method of transfer in the secondary market.

Early forms of transfer restriction required borrower consent to such a transfer unless it was to an existing Lender, an affiliate of such a Lender, or it was made while an Event of Default was continuing[156]. Consent of the borrower could not be "unreasonably withheld or delayed" and was deemed to be given within a relatively short timeframe unless the borrower specifically confirmed it was withheld[157]. Changes to the identity of parties who buy and sell loans in the secondary market, particularly in the context of the increased participation in the market of "vulture funds" and other specialist purchasers of distressed loans, resulted in borrowers seeking to extend restrictions on transfer. Those initially focussed on transfers to entities other than banks or similar such institutions, however, cases such as *Grant and Others*

[155] For an interesting analysis of the development of the "standing offer" technique facilitating transfer by way of novation, see M. Hughes, "Transfer Ability in Syndicated Lending" (January 2007) Law and Financial Markets Review 21 (at p.22). The Court of Appeal has also confirmed the veracity of "deemed consent" provisions typically included in primary loan agreements, see *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd* [2010] EWCA Civ 1335.
[156] Supra n.98.
[157] *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd*, supra n.154.

v WDW 3 Investments Ltd[158] and *The Argo Fund Ltd v Essar Steel Ltd*[159] highlighted the risks of such an approach. Phrases like "bank or other financial institution" would not be limited to entities resembling a bank. Such an entity would not have to be a lender or deposit-taker or an established trader in loans; it would not need to satisfy any of the standards on probity that must be met by a bank; and it would not be required to have the funds available to satisfy any future drawdowns that may be available to the borrower, for example, under a revolving loan. In the view of the Court of Appeal such a restriction only required that the transferee was "a legally recognised form of being, which carries on its business in accordance with the laws of its place of creation and whose business concerns commercial finance"[160]. Such a restriction would also not extend to entities operating on its own behalf in the field of regulated finance and would permit transfers to entities which act as agents, trustees or fiduciaries either for buyers or borrowers or for the providers of services. Critically, from a borrower's perspective, such a restriction would also permit transfers to so called 'vulture funds' which may be expected to take a more aggressive approach to enforcement of the loan[161].

In seeking to impose restrictions on transferability, borrowers have also increasingly focussed on the breadth of the wording used in transfer restrictions, particularly those describing the types of transfer to which the restriction will apply. This is partly a consequence of decisions indicating the court will construe the type of transfer narrowly unless the wording explicitly indicates otherwise. In *Barbados Trust v Bank of Zambia*[162], for example, although it was unnecessary to decide the point, two members of the Court of Appeal would have been prepared to hold that a clause expressly restricting assignment did not extend to a declaration of trust. If the parties wished to restrict declarations of trust in addition to assignments, they should have done so explicitly[163]. This approach is consistent with that taken by Lightman J

[158] *Grant and Others* as joint administrators of Olympia Securities Commercial Plc (in administration) v WDW3 Investments Ltd and another [2017] EWHC 2807 (Ch).
[159] [2006] EWCA Civ 241.
[160] *Essar Steel Ltd v The Argo Fund Ltd* [2006] EWCA Civ 241 at [51], *per* Auld L.J., who was quoting from the Judgment of Aikens J. at first instance. See also *Barbados Trust Co Ltd v Bank of Zambia* [2007] EWCA Civ 148.
[161] *ibid*. See also *Re Olympic Securities Commercial plc (in administration)* and *Ors v WDW 3 Investments Ltd and Anor* [2017] EWHC 2807 (Ch).
[162] [2007] EWCA Civ 148.
[163] ibid at paras [43] and [89].

in an earlier case[164] and, while the reasoning in both is somewhat controversial and has been subject to criticism[165], neither have been overturned, and has resulted in transfer by way of trust being used in the secondary market in order to avoid restrictions in the underlying loan on transfers by way of assignment[166].

More recently borrowers and their sponsors, no doubt mindful of the approach taken by the court in the interpretation of transfer restrictions; the changing nature of the parties now active in the secondary market; and the changes that have been made to the form and substance of sub-participation agreements, have increasingly sought to impose more extensive restrictions in primary loan market agreements. Those now include:

(i) **A Pre-Approved Lender List**

One approach is to include an extensive list, often referred to as a "White List", of named entities to which a Lender of Record may transfer or assign all or part[167] of their interest in the underlying loan without borrower consent. Borrower consent is required for transfer to any party not included on the "White List", however, that cannot be unreasonably withheld or delayed and the LMA has recently observed[168] the existence of such a list is not intended to enable borrowers to argue they can reasonably withhold consent to requests for transfer simply on the basis that the prospective transferee is not included on the list[169]. The pre-approved lenders are frequently limited to regulated banks and their affiliates, including related CLO vehicles established by such banks. The use of a specific pre-

[164] *Don King Productions Inc. v Warren* [2000] Ch. 291.
[165] P. MacMahon, 'Rethinking assignability', [2020] C.L.J. 79(2), 288; A. McKnight, 'Contractual Restrictions on a Creditors Right to Alienate Debts' [2003] J.I.B.L.R. 1, 43; A. Tettenborn, 'Trusts and Unassignable Agreements Again' [1999] L.M.C.L.Q. 353.
[166] Including the public CLO securitisation market. See Penn, Smith and Hawkins, 'Don King – Panacea or Poison?' [1999] 14 J.I.B.L. 316.
[167] The parties included on the "White List" may also be required to maintain a minimum credit rating in order to remain "eligible transferees". This additional restriction is increasingly common where further drawdowns are available under the facility. See also the analysis below on further restrictions that may apply to the amount that may be transferred by a Lender, in particular the concept of "minimum hold".
[168] LMA: 'Inhibitors to liquidity in the loan market (published July 2021) p.7.
[169] The LMA also cautions that lenders should consider "who is responsible for the maintenance of [the] White List, and how to ensure it is readily available for review by syndicate members, supra n.159 section 3, A1.

approved lender list was developed, in part, to address the uncertainty of restricting transfers to "banks or other financial institutions"[170].

(ii) **A Prohibited Lender List**

An alternative approach, often referred to as a "Black List", either names specific entities to which the underlying loan may not be transferred and/or identifies types of entities which are prohibited, for example, "vulture funds" or "buyers of distressed assets", and is typically intended to capture funds that focus on multiple investment strategies where the acquisition of distressed assets and/or the pursuit of a loan to own strategy is neither the principal nor dominant strategy to acquire such assets. Drafting transfer restrictions by reference to the types of entities that engage in certain activities involves a degree of uncertainty; there is little case law to provide guidance on their meaning and the nature of the entities intended to be caught and, as a consequence, the business they operate should be set out in as much detail as possible in order to avoid the potential problems of interpretation referred to earlier.

(iii) **Competitors of the borrower**

It is also increasingly common for transfer restrictions to extend to parties which are competitors of the borrower or, where the borrower is a portfolio company of a fund type sponsor, the sponsor and related entities. There is no standard definition for such 'competitors' and, in order to limit the risks associated with contractual interpretation, mentioned previously, the restriction should be drafted as broadly and clearly as possible if it is to achieve its intended objective.

(iv) **"Minimum hold" obligations**

Another approach, typically taken in addition to the inclusion of specific transfer restrictions, is an arrangement entered into by the borrower and the Lender of

[170] Supra n.159; see also P. MacMahon's comments on the *Barbados Trust* case supra n. 164 at p.296.

Record pursuant to which the latter agrees to maintain an agreed percentage of the total commitment (both drawn and undrawn) under the loan. This is often referred to as a "minimum hold" requirement and is sometimes included in a separate agreement between the lender and the borrower[171]. The "minimum hold" obligation may fall away once the loan is fully drawn down by the borrower or the availability period for further drawdowns has expired, and in such cases the obligation would typically only restrict a lender from transfers that included its obligation to lend, namely novation. Where the borrower is required to satisfy further material conditions prior to any future drawdown, it may also seek to restrict any transfer that gives the transferee any influence or control, directly or indirectly, over the decision to approve (or restrict) such drawdowns.

(v) **Transfer restrictions on sub-participation**

In light of the changes made to the form and substance of sub-participation agreements it is not surprising borrowers have become increasingly concerned about the technique and the extent to which it should be caught by transfer restrictions included in primary market loan agreements[172]. As will be apparent from the analysis set out above those changes may have a significant impact on the borrower. However, one of the main difficulties facing borrowers seeking to assess the potential implications is the fact they may differ significantly depending on the terms included in the actual agreement. The rights and obligations under one form of sub-participation agreement may be materially different from those arising under another. In order to clarify the potential impact some borrowers now require full details of the proposed sub-participation, including in some cases a draft of the actual agreement, to be provided before any agreement is entered into. This potentially undermines a fundamental premise upon which the technique was originally based; that it did not require the involvement of the

[171] Optional language covering the concept of "minimum hold" is contained in clause 30.3(b) (other conditions of assignment or transfer) of the LMA Leveraged Loan Agreement (published March 2020). No such requirement is contained in LMA Investment Grade precedent agreements.
[172] LMA guide, "Inhibitors to liquidity in the loan market" (published 28 July 2021) Section 3 A.III.

borrower. The borrower was never intended to become aware a sub-participation had been entered into by its lender, much less the actual terms of that agreement. Other restrictions include a requirement that the sub-participation must only give rise to contractual, debtor/creditor style, rights between the sub-participation and the Lender of Record and must not contemplate the creation of an ownership interest in the loan or any privity of contract between the sub-participant and the borrower, either immediately or in the future. This approach is clearly intended to restrict the inclusion of elevation style mechanisms. Unsurprisingly voting and control rights over the loan are often a borrower's greatest concern[173], particularly since such control is exercised by an unknown sub-participant, behind the scenes, so to speak, in circumstances where the borrower is unaware of both the identity of the sub-participant and the extent to which it is able to influence and control the Lender's decisions. Restrictions on the 'transfer' of such rights, or a requirement for the borrower to consent before voting rights can pass to a sub-participant, are increasingly becoming a subject of negotiation in the primary loan market. Few would argue this focus has arisen both because of the increased presence of institutional investors in the secondary market, particularly as buyers of leveraged and distressed loans, and because of the changes that have been made to the wording of LMA style secondary debt trading documents, some of which now contemplate the granting of extensive voting and control rights to the sub-participant[174]. As originally conceived, sub-participation agreements were not intended to impact the relationship between the Lender of Record and the borrower, including the lender's unfettered ability to manage all aspects of the loan[175], indeed, they were structured to avoid that. They were intended to transfer only credit risk in the loan and were, therefore, largely ignored by borrowers[176]. That original conception may continue to apply

[173] This is recognised by the LMA "Borrowers' concerns around these types of transactions are that an unknown third party may be influencing a lender's decision in relation to a facility", *ibid* section 3 A III.
[174] Supra n.73 clause 6.2. See above "Control rights over the underlying loan".
[175] Other than in respect of material issues that might adversely impact the sub-participant, for example, modifications that forgive, postpone or reduce principal or interest on the loan or which released security, see "How and why did the original form of sub-participation agreements change' above.
[176] The LMA recently recognised "restrictions relating to sub-participations have started to creep into transactions. Supra n.171 at p.7.

where no voting rights are specified and no elevation mechanism is included in the sub-participation agreement[177], however, that can no longer be assumed by borrowers. The current LMA forms of sub-participation may not initially transfer any ownership interest in the loan, or create formal privity between the sub-participant and the borrower, at least not until the elevation mechanism has been triggered, but, as the LMA has recognised, that mechanism, when taken together with the representations made by the Lender of Record (that it owns the loan and will not transfer or encumber it other than in favour of the sub-participant)[178], "illustrate the LMA [sub-]participation is designed to transfer an ownership interest in the loan to the [sub]-participant". That mechanism is included in the agreement immediately on execution, as a future right, and is not subject to material contingency[179]. Furthermore, if the sub-participation grants extensive voting rights, in the manner contemplated by the LMA precedent agreement[180], it will give the sub-participant immediate substantive indirect control over the Lender's interest in the underlying loan. Those indirect rights will become exercisable directly by the sub-participant following elevation by means of a Bi-lateral Termination and Transfer. Even where that is not possible, because of transfer restrictions in the underlying loan, the sub-participant may still obtain enhanced voting and control rights where that elevation includes a 'Multilateral Termination and Transfer' in favour of a third party 'Buyer' who is not subject to those transfer restrictions[181].

Conclusion: the market needs sub-participation to continue to play an important role promoting liquidity in the secondary market

[177] As is the case where clause 6.2(i) of the LMA Master Funded Participation Agreement is included supra n. [73].
[178] See "Does elevation change the legal characterisation of sub-participation?" above.
[179] Other than in respect of limitations/restrictions that apply in the underlying loan, however, the ability to require either a bilateral or a multilateral termination to be entered into significantly reduces the significance of any such limitations.
[180] Supra n.73.
[181] This might be achieved via the increased control over voting rights given to the sub-participant in the new sub-participation agreement entered into between the sub-participant and the third party 'Buyer'.

The various forms of sub-participation currently used in the market are almost unrecognisable from the relatively simple form of agreement originally developed. That original form made a significant contribution to the development of the secondary loan market and the lack of a borrower consent or consultation requirement has been an important part of that contribution[182]. That is now changing. Sub-participation is no longer viewed by borrowers as a purely derivative instrument, which transfers only economic risk, but rather a method of transfer which potentially impacts rights and obligations under the underlying loan and also its relationship with the Lender. As a consequence, borrowers are increasingly seeking to restrict its use and that is starting to impact liquidity in the secondary market. Their ability to impose such restrictions, and the corresponding ability of lenders to resist, will depend on many factors relating primarily to the relative bargaining strength of the parties at the time and the broader economic conditions that prevail in the market.

A robust, liquid secondary market is an increasingly important factor both in the underwriting capability of lenders in the primary market and also in respect of ongoing credit risk and portfolio management, and any developments which inhibit liquidity should be of concern to all market participants. As the European economy recovers from the impact of the Covid-19 pandemic borrowers will need access to the type of debt facilities available in the primary market. The ability of that market to satisfy those needs will be significantly reduced if the number and range of investors is limited by transfer restrictions included in primary market documentation, which either place restrictions[183] on their entry, or bar it completely[184].

Sub-participation cannot revert to the simple technique that was originally developed and there is no doubt the form and content of sub-participation agreements will continue to change but if it is to continue to play an important role promoting liquidity in both the primary and secondary markets the fundamental features upon which it was originally based need to be better respected, particularly in respect of loans that are performing. If they are not, it is

[182] Supra n.171 at p.7.
[183] For example, by requiring borrower consent or including either a "White" or "Black" List in respect of "eligible transferees".
[184] For example, in the case of vulture funds or specialist distressed traders. See "The development of transfer restrictions and their potential impact on sub-participation" above.

likely restrictions will continue to be a focus of negotiation between the parties and that will inevitably inhibit liquidity in both markets.