PRIVITY OF CONTRACT IN AN AGE OF DERIVATIVE ECONOMIC INTERESTS

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Abstract:

Privity of contract continues to be a fundamental principle in the medium-term loan market where relationships continue to be important, however, certain types of derivative instruments, which are frequently used to transfer, reduce, or acquire credit exposure in a loan, are undermining privity. Such instruments were originally intended to create and transfer only an economic or 'synthetic' interest in the underlying loan, not some form of legal or beneficial interest, and they were never intended to create privity of contract with the underlying debtor. This article is, so far as the author is aware, the first to examine in detail the potential impact such instruments have on privity of contract to the underlying loan contract or 'reference asset' in respect of which the derivative economic interest is created. It will focus on one of the earliest, and still one of the most frequently used, derivative contracts, the sub-participation agreement, however, many of the issues raised apply equally to other more conventional forms of OTC derivative contracts used in the market, including total return swaps and credit default swaps, and reference will also be made to some of those. This article argues that sub-participation agreements should no longer be characterised as derivative style agreements which transfer only an economic interest, but rather as contracts that potentially impact the rights and obligations the parties to the underlying loan contract bargain for, and thereby violate the borrower's freedom of contract by undermining privity of contract between the borrower and its lenders and creating a form of privity with the undisclosed sub-participant.

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Introduction

Notwithstanding considerable criticism and regular talk of its demise by judges, academics and law reform bodies for almost a century[1], the doctrine of privity of contract, that only the parties to a contract have the right to enforce its terms, continues to be an important principle of English law. The Contracts (Rights of Third Parties) Act 1999 (the 'CRTPA') fundamentally changed the privity doctrine by allowing contracting parties to confer enforceable rights on third parties, but it did not, as some commentators have suggested[2], abolish it. Where contracting parties do not intend to confer such rights on third parties, which is frequently the case, they can expressly exclude the CRTPA, in which case the privity doctrine will continue to apply to the contract, and the rights of third parties will continue to be governed by the common law rules and techniques that have been developed to enable a person who is not a party to the contract to enforce its terms. This article considers the continuing importance of the privity doctrine in the context of loan contracts in the critically important term loan market which is where most corporate borrowers obtain debt finance to fund their ongoing business needs[3]. The loan contracts used in that market are both long, often running into many hundreds of pages, and complex, and include a combination of rights (which may be absolute or discretionary[4]) and obligations (which may be absolute, conditional or discretionary) applicable to both the lender and the borrower. The contracts are also typically 'dynamic'[5] and

[1] See R. Merkin ed., *Privity of Contract* (Lloyds Commercial Law Library 2000); E. Peel, *Treitel The Law of Contract*, (15th ed. Sweet & Maxwell 2020) [14-002 and 14-015]; and H. Beale ed., *Chitty on Contracts*, (34th ed. Sweet & Maxwell 2022). See also the Law Commission report recommending reform of the privity doctrine; Law Commission Report N. 242, *Privity of Contract: Contracts for the Benefit of Third Parties* (1996). For an interesting article challenging that condemnation see S. Smith, *Contracts for the Benefit of Third Parties: in Defence of the Third-Party Rule*, 17 Oxford J. Legal Stud 643 (1997), which references the voluminous literature and numerous cases condemning the privity doctrine.

[2] See R. Merkin, n.1.

[3] See Amelia Slocombe and Nicholas Voisey (ed.) *Leading the Way: The LMA 25 Years in the Loan Market*, (2021) Loan Market Association publication, at p.15, which references Dealogic report that EMEA loans arranged in 2020 reached US$1.2 trillion with UK companies representing the highest proportion of borrowers (26.6% of total Western European syndicated lending volume (at p. 37)).

[4] The distinction between an absolute contractual right and a contractual discretion is not always an easy one to make. In *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200 [2013] BLR 265, Jackson LJ drew a distinction between "making an assessment or choosing from a range of options, taking into account the interests of both parties" (which is a contractual discretion) and "a simple decision whether or not to exercise an absolute contractual right" at [73] (which is not). The distinction will depend on the construction of the clause in the context of the agreement as a whole. For a general discussion of contractual discretion see P. Davies *Excluding Good Faith and Restricting Freedoms* (ch. 6) in P. Davies and M. Raczynska (eds) *Contents of Commercial Contracts: Terms Affecting Freedoms*, (Hart Publishing 2020); R. Hooley *Controlling Contractual Discretion*, (2013) 72 CLJ 65; and H. Beale ed. *Chitty on Contracts* (34th ed. Sweet & Maxwell 2022) [1-053-1-061].

[5] See M. Roberts, *The role of dynamic renegotiation and asymmetric information in financial contracting*, Journal of Financial Economics 116 (2015), 61, which uses empirical data from Securities and Exchange Commission filings to show a typical term loan is renegotiated every nine months, or five times during its term.

'incomplete'[6], in the sense the parties impliedly recognise, when they execute their bargain, the terms will need to be renegotiated, varied and/or amended, often numerous times, during the term of the contract[7]. Because of their complex, dynamic and incomplete nature, relationships[8] continue to play an important role in such contracts since it will be each respective contracting counterparty who will control or influence the exercise of the various rights or discretions, or be subject to the corresponding duties and obligations, for which the parties' bargain when they enter into the contract. Clauses seeking to preserve privity of contract in respect of that relationship, and restrict the ability of third parties to control or influence the ability to enforce rights or discharge obligations, are included in the loan contracts used in the market, however, those clauses seek to restrict only legal or equitable rights or interests that might be enjoyed by third parties, not economic rights or interests, because it was felt only the former could impact privity of contract between the parties. That is now changing.

Various forms of derivative contract[9] have been developed over recent years to transfer, reduce or acquire credit exposure in a debt instrument, typically loans and bonds. Such contracts were developed with the intention to transfer only an economic interest (sometimes referred to as a 'synthetic' interest) in the underlying debt instrument or 'reference asset' on which the derivative contract is based, not some form of legal or beneficial interest, and they were never intended to create privity of contract with the underlying borrower. This article will argue that is now changing, specifically with reference to one of the most common forms of derivative

See also M. Roberts and A. Sufi, *Renegotiation of financial contracts: evidence from private credit agreements*, Journal of Financial Economics 93 (2009) 159; and Hart and Moore, *Default and Renegotiation: a dynamic model of debt*, Quarterly Journal of Economics, 113 (1998).

[6] Loan contracts which frequently need to be renegotiated when a borrower's circumstances change, in a positive or a negative way, have been characterised as 'incomplete contracts' because they do not contemplate every eventuality and renegotiation is the process through which those contracts are 'completed', see S. Sanga, *Incomplete Contracts: An Empirical Approach*, Journal of Law, Economics and Organization (2018) 34 (4) 650. M. Roberts, n.5 at p.77 also recognises the 'incomplete' nature of loan contracts referred to by S. Sanga; "Renegotiation is also a means to dynamically complete contracts, which are inherently incomplete".

[7] See M. Roberts, n.5 at p. 61-63.

[8] Experiences during the Global Finance Crisis 2007-2009 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 [waive and amend loans] during the credit crisis of 2007-2009, have been found to be those with whom [borrowers] had close and productive relationships" Martin O'Donovan in *The Borrower/Lender Relationship: the Borrower Perspective*, N. Volsey and A. Slocombe (eds), *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 (2021) at p111. See also the interesting discussion of lessons to be learnt from the Covid-19 pandemic, in the context of changes required to be made to loan agreement terms, in *The Association of Corporate Treasurers ('ACT') A Borrower's Guide to LMA's Investment Grade Agreements*, produced by Slaughter and May (6th ed. November 2022) (the 'ACT Guide'), at pp. 74-76.

[9] This article will focus on derivative contracts that transfer credit risk (and reward) in the underlying loan or reference asset.

style contracts used in the international debt markets, namely the sub-participation agreement, however, many of the issues raised apply equally to other more conventional forms of OTC credit derivative contracts used in the market, including total return swaps and credit default swaps, and reference will also be made to some of those. This article argues sub-participation agreements should no longer be viewed as purely derivative style instruments, which transfer only an economic interest, but rather as contracts that potentially impact the rights and obligations the parties to the underlying loan contract bargain for, and thereby violate freedom of contract for the borrower by creating a form of privity between the borrower and the sub-participant and undermine privity (and the broader relationship) between the borrower and the lender. In making this argument, the article proceeds as follows: Section I maps out the key contractual terms the parties typically bargain for in term loan agreements; Section II considers the importance of privity of contract in the context of the complex, dynamic and incomplete nature of those terms, and includes reference to the terms which seek to preserve privity between the lender and the borrower and restrict the conferment of rights on third parties; Section III examines the original form and legal characterisation of the sub-participation agreement; Section IV examines how that has changed in recent years; the extent to which those changes now potentially impact the rights, obligations, duties and discretions bargained for; undermine privity of contract between those parties; and creates a form of privity between the sub-participant and the borrower; Section V concludes.

This article makes the assumption that the underlying loan will be syndicated immediately upon the loan agreement being entered into by the parties, as is often the case, so there will be multiple lenders who agree to make their respective 'commitment' in the relevant 'facilities'[10] to a single borrower and also an agent bank (the "Agent"), acting as agent for the lenders, however, the principles will be the same in the case of a bi-lateral loan where there is only one lender at the time the loan agreement is executed.

[10] The loan agreement will often contemplate one or more 'loan facilities' to be made available to the borrower under the terms of a single agreement including, for example, a 'term loan facility' which the borrower is able to drawdown in a single amount or in tranches until the relevant facility limit is reached; and a 'revolving facility' which the borrower is able to drawdown, repay and reborrow (hence it is often referred to as a 'revolver'), in whole or in part, during the term of the facility. Those facilities may be made available in a single currency or in multiple currencies, known as 'multi-currency facilities', which enable to borrower to switch between currencies during the term of the facility.

I. The Terms Typically Included in International Term Loan Agreements

The bargained for terms agreed between the parties to an international term loan agreement will always be subject to detailed, often lengthy, negotiation between the parties, however, those terms are typically based on one of the recommended form agreements produced by the London based Loan Market Association (the "LMA").[11] The LMA recommended forms commonly used in the market are both long and complex and it is not the purpose of this article to describe all those forms or their terms in detail, however, it is important to draw a conceptual map of the various forms of loan agreement produced by the LMA, and the key terms that are included, in order to understand the nature of the rights, obligations, duties and discretions[12] bargained for by the parties and the potential impact a sub-participation may have on them. In drawing that map this article will focus primarily on two of the current LMA recommended form documents, namely the Multicurrency Term and Revolving Facilities Agreement for investment grade borrowers, issued 28 February 2020 (the "LMA Multicurrency and Revolving Facilities Agreement"), and the Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions (Senior/Mezzanine), issued 20 March 2020 (the "LMA Senior/Mezzanine Facilities Agreement"). However, the LMA takes a consistent approach to both the form and substance of all its recommended form loan agreements, so many of the principles will be the same in the other recommended form loan agreements produced by the LMA.

(i) The Obligation to Lend

The simple loan contract construction is one based on the assumption the borrower has an immediate need to borrow for a specific period. The loan contract will therefore provide for the loan to be advanced to the borrower immediately upon execution of the contract and repaid on the agreed repayment date. At no time in such an arrangement is the lender under a

[11] The LMA was created in December 1996 by banks operating in the European, Middle Eastern and African ("EMEA") markets. The principal aim of the LMA is to promote liquidity in both the primary and the secondary loan markets and although its work initially focussed on the production of 'recommended forms of secondary trading documentation' it soon turned its attention to the development of a comprehensive set of 'recommended' primary loan agreements covering a wide range of facilities, including various forms of 'Investment Grade' loan agreements, 'Leveraged Loan' agreements, and 'Real Estate Finance' loan agreements. For an interesting account of the origin of the LMA, see Amelia Slocombe and Nicholas Voisey ed. *Leading the Way: The LMA 25 Years in the Loan Market*, Ch. 1 History of the LMA and the Syndicated Loan Market, (2021) Loan Market Association publication.

[12] See n.4.

commitment to lend; it advances the funds immediately it enters into the contract and has no further obligation to lend even if the loan is repaid early. Loan agreements in the medium-term loan market are structured on a more complex basis than this simple construction. The most fundamental, often the only, obligation, on the part of the lenders, is to make the loan available but the nature of that obligation will rarely be so simple. Its precise commercial nature and legal terms will depend on the type of loan agreement entered into between the parties, for example, whether it is a term loan, where the lenders commit to lend a specified amount over a set period of time (the "term"); or a revolving loan, which is similar to a term loan in that it provides a borrower with a maximum aggregate amount over a specified period but, unlike the term loan, that period is typically for the entire duration of the loan, during which the borrower is able to draw down, repay and re-draw all or part of the loan at its discretion; or both; whether all or part of the loan can be drawn down under one or more different types of facility (each typically referred to as an "ancillary facility"[13]); and whether it is available in a single currency or multiple currencies.[14] However, whatever those terms, under an LMA recommended form loan agreement the obligation to lend does not arise immediately upon the loan agreement being entered into by the parties. The obligation is conditional at that stage and subject to the borrower satisfying a number of conditions, referred to as 'conditions of utilisation'. In chronological order those include the 'initial conditions precedent', which, as their name suggests, are required to be satisfied before the first drawdown of the loan by the borrower, "in form and substance satisfactory to the Agent"[15]. The lenders authorise the Agent to make the required subjective determination[16] and provide the necessary confirmation to the borrower but that authority may be revoked, at any time prior to the Agent giving the confirmation, by the "majority lenders", i.e., lenders whose participation in the loan is more than $66^2/_3$ per cent[17]. It is only following confirmation by the Agent that the initial conditions precedent have been satisfied (or waived) that the borrower is able to deliver a utilisation request seeking to drawdown one or more of the facilities made available under the loan agreement. The lenders'

[13] See n.22.
[14] Typically referred to as 'multicurrency' loan facilities, see n.10.
[15] Cl 4.1 LMA Multicurrency Term and Revolving Facilities Agreement.
[16] See n.4. The case law on the exercise of a discretionary power, as opposed to an absolute right, does not provide a consistent indication of how a court might interpret the Agent's power but recent decisions do indicate some fetters apply to the discretion, see n.52. For an analysis of controls of discretions generally see M. Raczynska, *'Good Faith and Contract Terms'*, (Ch. 5) and P. Davies, *Excluding Good Faith and Restricting Discretions*, (Ch. 6) n. 4. See also R. Hooley *Controlling Contractual Discretion*, n.4.
[17] Cl 4.1(b) LMA Multicurrency Term and Revolving Facilities Agreement.

obligation to comply with any[18] such request is then subject to 'further conditions precedent'[19], namely that no 'default'[20] is continuing under the loan, or would result from the making of that advance, and the 'repeating representations', an important sub-set of the representations and warranties made by the borrower when the loan agreement is entered into, continue to be true in all material respects. The 'no default' condition brings into play compliance by the borrower with its many ongoing obligations under the loan agreement, including the undertakings and covenants and the events of default[21].

A number of the LMA recommended form agreements contemplate additional facilities being made available by some of the lenders during the term of the loan i.e. following the original bargain being agreed by the parties. Those may include 'incremental facilities'[22], where a lender may increase the amount of its 'commitment' under one or more of the facilities it has agreed to make available, and, as previously indicated, where the loan agreement includes a revolving facility,[23] the possibility that all or part of each lenders' commitment may be made available under a different form of facility, for example, an overdraft facility; a letter of credit facility; a short term loan facility; a derivatives facility; a foreign exchange facility; or "any other facility or accommodation required in connection with the business of the [borrower]…." [24]The availability of 'incremental' and 'ancillary' facilities is subject to future agreement between each lender and the borrower and, in the case of ancillary facilities, is linked to the availability period and term of the revolving facility. However, various LMA recommended form loan agreements do contemplate the lenders making such facilities available and, if a lender agrees to do so, the broad terms on which they will be provided are set out in the original loan agreement[25].

(ii) The Cost of Borrowing

[18] A utilisation request will be required to be delivered whenever the borrower wishes to make a drawdown under any of the facilities made available so, for example, in the case of a revolving loan, multiple utilisation requests may be delivered during the term of the loan.
[19] Cl. 4.2 LMA Multicurrency Term and Revolving Facilities Agreement.
[20] This is typically forward looking and wider than an 'event of default' under the loan agreement.
[21] Discussed in greater detail below, see section I(vii).
[22] See Cl.10. LMA Senior/Mezzanine Facilities Agreement.
[23] Such a feature is included in the LMA Senior/Mezzanine Facilities Agreement, see Cl.9. 'Ancillary Facilities'.
[24] Such facilities are typically described as "ancillary facilities", see Cl. 9.1(f) LMA Senior/Mezzanine Facilities Agreement.
[25] Cl. 9.3 LMA Senior/Mezzanine Facilities Agreement.

International term loans typically charge a floating rate of interest which comprises the relevant market rate[26]and the margin. The margin component, which reflects the lenders' assessment of the borrower's credit risk at the time the loan agreement is entered into, was historically fixed for the entire term of the loan agreement on the assumption the borrower's credit standing would be maintained, or at least not worsen, throughout the term of the loan, and many of the provisions we consider below were included, at least in part, to buttress that assumption[27]. Empirical research[28] suggests that approach is now changing and the parties recognise the terms of the loan agreement, including its margin[29], will need to be renegotiated, often a number of times[30], during the term of the loan, indeed, that research shows "frequent renegotiation is an integral part of bank lending……..It is precisely because borrowers are able to renegotiate the terms of their contracts that they are willing to accept such restrictive contracts in the first place"[31]. Renegotiation may be initiated by either the lenders or the borrower and, once agreed, the terms are typically reflected by way of an amendment or variation[32] to the loan agreement rather than by means of an automatic adjustment mechanism included within the original terms.[33]

(iii) Terms Protecting the Lenders' Financial Position and Rate of Return

[26] Historically Libor served as the globally accepted market benchmark but that is currently in the process of being phased out following the Libor scandal. It has already been replaced by SONIA for new sterling denominated loans and by SOFR for new USD denominated loans. For a detailed account of the transition from Libor to risk free rates see The ACT Guide n.8 Part II/Risk-Free Rates In The Loan Market pp. 19-66; D. Hon and D. Skeie, *LIBOR: Origins, Economics, Crisis, Scandal and Reform, Federal Reserve Board of New York Staff Reports* N. 677 (March 2014) and M. McKee and N. Millar, *The Implications of Moving to SONIA*, (2020) 35 JIBLR 6, 233.

[27] H.S. Pigott, *The Historical Development of Syndicated Eurocurrency Loan Agreements* (1982) 10 International Business Lawyer 199.

[28] See M. Roberts n.5. See also M. Roberts and A. Sufi, *Renegotiation of financial contracts: evidence from private credit agreements*, Journal of Financial Economics 93 (2009) 159; and Hart and Moore, *Default and Renegotiation: a dynamic model of debt*, Quarterly Journal of Economics, 113 (1998).

[29] See M. Roberts, n.5 at p.62.

[30] Loan contracts which do not contemplate every eventuality and therefore require frequent renegotiation, have been characterised as 'incomplete contracts', see S. Sanga, n.6 and M. Roberts, n.5.

[31] See M. Roberts, n. 5 at p.77.

[32] The mechanism for agreeing amendments or variations to an LMA style syndicated loan agreement is considered below, see Section I (iii) 'Events of Default'.

[33] Some loans, particularly those made available in the leveraged loan market, often include 'margin ratchets' which automatically reduce the margin if the borrower achieves certain pre-set deleveraging targets, and 'sustainability-linked loans', basically loans that comply with Environmental, Social and Governance ('ESG') standards, often provide for a reduction or increase in the margin depending on the performance of the borrower against pre-agreed ESG-related criteria and targets. For an interesting account of the current status of sustainability-linked lending in the term loan market, see The ACT Guide, n.8 pp. 83-101.

LMA recommended form agreements include several provisions protecting the lenders' financial position and their expected rate of return on the loan. These include so called 'market disruption' provisions[34], which allow the lenders to pass on to the borrower their actual cost of funding in place of the market benchmark that has been selected, in the event of significant market disruption. The procedure to be followed in such cases is complex and beyond the scope of this article, however, each lender is ultimately able to select its actual cost of funding from "whatever source it may reasonably select"[35]. As soon as a market disruption event occurs either the Agent or the borrower can require the other to enter into negotiations for up to 30 days to try to agree another basis for calculating the rate of interest[36] but any alternative basis agreed during those negotiations is not binding unless agreed by all lenders and the borrower.

LMA recommended forms also adopt the traditional market practice that it is the borrower which takes the risk of a change of law or regulation. The key provisions relate to the borrower's obligation to make all payments to the lenders gross (i.e. without withholding tax) and to cover any increased costs incurred by a lender as a result of its compliance with any change in law or regulation which occurs after the agreement has been entered into. The clauses regulating these issues are again complex, and their precise terms are beyond the scope of this paper, however, since any additional costs are likely to be determined primarily by reference to the type of lenders included in the lending syndicate[37] and the jurisdiction from which each lender makes its various commitments under the loan available to the borrower, these are issues on which the borrower will focus when it negotiates the original terms of its bargain with the lenders[38].

(iv) Payment of Interest and Repayment of Principal

[34] LMA Multicurrency Term and Revolving Facilities Agreement, Cl. 11.3.
[35] LMA Multicurrency Term and Revolving Facilities Agreement, Cl. 11.4(a)(ii), see n.68 for a more detailed analysis of some of the implications of the discretionary nature of this right.
[36] LMA Multicurrency Term and Revolving Facilities Agreement, Cl. 11.4(b).
[37] i.e. is the lender a 'qualifying lender' to which the borrower can pay interest gross (without any withholding for tax) and is it regulated i.e. subject to ongoing, and potentially increasing, regulatory costs, for example, in connection with capital standards published by the Basle Committee on Banking Supervision.
[38] See *The ACT Guide*, n.8, Section 6: *Additional Payment Obligations*.

The borrower is obliged to make periodic payments of interest at the agreed rate and to repay the various facilities on specific dates that are set out in the agreement. In a term loan facility that is typically in accordance with an agreed amortisation schedule or at the end of the term of the loan and, in the case of a revolving facility, at the end of the relevant interest period (most commonly quarterly) for each amount drawn down under the facility, although the borrower is typically able to re-draw the amount it repays (often referred to as a "rollover loan") provided it is able to satisfy the various conditions to drawdown, referred to earlier, on the date of 'rollover'[39].

(v) Terms Relating to The Lender's Initial and Ongoing Due Diligence and Monitoring

Lenders in the international term loan market perform due diligence on the borrower prior to entering into the loan and much of that is reflected in the legal and factual issues covered by the representations and warranties given by the borrower when it enters into the loan agreement. The decision by the lenders to enter into the loan, and the 'price'[40] payable by the borrower, are set at this stage by reference to the information captured as part of that due diligence process and the representations and warranties given by the borrower. If any of the representations and warranties are found to be untrue or misleading in any material respect, it will trigger an event of default,[41] and enable the lenders to cancel their obligation to lend and accelerate repayment of any outstanding borrowings. As we have already seen, the borrower will also need to refresh and repeat key 'repeating' representations and warranties whenever it wishes to make a drawdown of any of the facilities[42]. The repeating representations are also deemed to be repeated on the first day of each interest period[43] and if any become untrue it will trigger an event of default. The representations and warranties, particularly those which are repeated, are often qualified by reference to 'materiality', which may be further defined by reference to a relatively detailed "material adverse effect" definition, or by reference to monetary thresholds.

[39] The conditions applicable to a rollover loan are typically less onerous, particularly for high credit quality borrowers, see *The ACT Guide*, n.8, p. 163.
[40] Which will include the margin component of the interest rate payable to compensate the lenders for the risk they take in lending, which has several aspects, the most important of which is credit risk, i.e. the risk the borrower will fail to repay all or part of the loan together with the interest.
[41] Cl. 23.4 LMA Multicurrency Term and Revolving Facilities Agreement and discussed further below.
[42] In the case of a revolving facility the repeating representations and warranties must continue to be true to all material respects at the date a utilisation request is delivered, and the date lenders make the relevant advance to the borrower – LMA Multicurrency Term and Revolving Facilities Agreement, Cl. 4.2.
[43] LMA Multicurrency Term and Revolving Facilities Agreement, Cl. 19.4

In addition to providing regular confirmation that the matters covered by the repeating representations continue to be true and correct, the borrower will also be required to provide information to the Agent during the term of the loan, to enable the lenders to monitor its business activities and financial condition, with a view to obtaining early warning of potential problems and acting as a trigger point for negotiations with the borrower to restructure the loan[44]. The information typically required to be provided by these so-called 'information undertakings' includes the ongoing financial statements of the borrower; compliance certificates confirming compliance with the financial covenants; any documents sent out by the borrower to its shareholders; details of any material litigations which might have a "material adverse effect" on the borrower; the occurrence of any 'default' (and, if requested, a certificate confirming no default is continuing); and "any other information regarding the financial conditions, business and operations of the borrower that any lender may reasonably request"[45].

(vi) Covenants Given by the Borrower

LMA style loan agreements also contain both positive and negative covenants which are couched as obligations of the borrower to do, in the case of positive covenants, or not to do, in the case of negative covenants, certain things. The positive covenants include fairly minimal 'general undertakings'[46] to maintain any consents and comply with laws affecting the loan but by far the most important, certainly from a monitoring perspective, are the financial covenants, which require the borrower to maintain certain financial targets, usually expressed as a ratio, such as tangible or minimum net worth; leverage or gearing (borrowings to tangible net worth); liquidity (current assets to current liabilities); and interest cover or cash flow (debt service to EBITDA[47]). The ratios included, and how they are set, will depend on the specific business of borrower and the various financial stress factors to which it may be subject.

The purpose of the financial covenants is to enable the lenders to monitor, regulate and preserve the credit quality of the borrower by reference to the assessment made by them when they

[44] See M. Roberts, n.5 at pp. 73-77.
[45] Cl. 20.4(d) LMA Multicurrency Term and Revolving Facilities Agreement.
[46] Cl 22 LMA Multicurrency Term and Revolving Facilities Agreement.
[47] Earnings Before Interest, Tax, Depreciation and Amortisation.

originally bargained for (and priced) the loan[48]. However, the parties recognise that most businesses, including those able to borrow in the term loan market, will change, especially over a period of three to seven years, which is the typical term of a medium-term loan agreement[49], and, therefore, the financial covenants (and possibly other terms of the agreement) may need to be renegotiated from time to time. Empirical research[50] indicates such negotiations are frequently initiated by borrowers, well in advance of any covenant breach, primarily in response to changing conditions which may impact the borrower's ability to satisfy certain of the financial covenants. In many cases those changes are not due to financial distress but rather changes in the operation, investment or financial policies of the borrower, many of which may result from the successful development and growth of the borrower's business. They are also initiated (by both lenders and borrowers) in response to an actual or anticipated covenant breach. In such cases, although the loan agreement will provide various 'self-help' remedies for the lenders if an event of default (breach or otherwise) occurs: to cancel or suspend any further obligation to lend; to accelerate repayment of any outstanding borrowings and/or convert the term loan into an 'on-demand' loan[51], the effect of exercise of these remedies on the borrower is likely to be severe and the lenders have a choice whether to exercise them or

[48] Another important purpose is to align the duties and incentivise directors of the borrower to take the interests of the lender into account when making decisions about the future conduct of the borrower's business, see L. Gulliver and G. Penn, *Negative Covenants in Loan Agreements* in *Contents of Commercial Contracts: Terms Affecting Freedoms*, in P. Davies and M. Raczynska eds. (2020 Hart Publishing) Ch. 8, pp 137-161, which focuses on negative covenants although similar principles apply in the case of financial covenants.

[49] Although most medium-term loans will fall within the three-to-five-year timeframe at origination, the term is often extended following negotiation between the parties. See M. Roberts, n.5 at pp. 63-67 which indicates maturity extension is a common cause of loan renegotiation.

[50] See M. Roberts, n.5 at pp.67-69.

[51] See Cl. 23.13 LMA Multicurrency Term and Revolving Facilities Agreement.

not[52]. That choice frequently results in a renegotiation of the loan agreement[53]. The financial covenants also provide the lenders with an early warning of potential changes to the borrower's business, which may be positive as well as negative, and which may trigger the need for amendments to be made to the loan agreement, or at least an opening for negotiations between the parties. This is because they are traditionally 'maintenance' based, meaning they are tested at regular intervals during the term of the loan[54], and linked to various remedies available to the Lenders[55]. In the event of breach, they enable the lenders to take pre-emptive action that might result in changes being made to their original bargain by way of a consensual restructuring of the loan agreement[56] although it is also possible that, within certain limits, failure to satisfy one of the ratios will simply trigger an increase in the margin rather than an immediate event of default.

The negative covenants included in LMA recommended form agreements are designed to maintain and preserve the position of the lenders in relation to both the business and assets of the borrower and its other creditors. They typically include restrictions on the ability of the

[52] That choice is probably an absolute contractual right in this situation, asserted by the lenders by way of 'simple decision', see n.4. See also Morley (t/a *Morley Estates v Royal Bank of Scotland Plc* [2020] EWHC 88 (Ch) [160] (Kerr J) affd. [2021] EWCA Civ 338 [71] (Males LJ), *UBS AG v Rose Capital Venture Ltd* [2018] EWHC (Ch) [56] (Chief Master Marsh) and *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest)* [2013] n. 3 at [73] (Jackson LJ), without an implied term restricting the decision of the lenders, see *Sweden Financial Limited, Manoel Fernando Garcia* [2010] EWCH 2133 (Comm); *UBS AG v Rose Capital Ventures Ltd* [2018] EWHC 2137 (Ch). However, see also *Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2018] EWCA Civ 355, [2018] 1 WLR 3529, a case involving a swap contract, in which the Court of Appeal did not find a contractual discretion but held some fetters applied to the exercise of contractual rights more generally, "It can, however, be inferred that the parties intended the power granted by clause 21.5.1 [requiring a valuation] to be exercised in pursuit of legitimate commercial aims rather than, say, to vex [Property Alliance Group] maliciously. It appears to us, accordingly, that [Royal Bank of Scotland] could not commission a valuation under clause 25.5.1 for a purpose unrelated to its legitimate commercial interests or if doing so could not rationally be thought to advance them" (at [169] Sir Terence Etherton MR, Longmore LJ and Newey LJ). At least one commentator has suggested this is "a sensible application of the proper purpose rule……, requiring a party to act in pursuit of legitimate commercial aims is not onerous and represents a suitably mild form of control", P Davies, *Excluding Good Faith and Restricting Discretion*, n. 3, at pp 109 – 110. However, the Court of Appeal in *Morley Estates v Royal Bank of Scotland* ibid, cast doubt on even a modest duty being applied to the exercise of contractual rights by means of a proper purpose rule. The court "would not necessarily accept that the bank was under any such duty [to act for a proper purpose] in its negotiations with Mr. Morley [the borrower]" at [71] (Males LJ) and even if the bank had mixed motives it would have made no difference because the judge at first instance had found "All the bank's actions were rationally connected to its commercial interests" at [191] (Kerr J).

[53] See M. Roberts, n.5 at p.62, whose research indicates that more than 75% of cases involving covenant breach result in a renegotiation of the loan agreement rather than enforcement by the lenders.

[54] In recent years there has been an increase in covenant light or 'cov-light' loans particularly in the leveraged finance market where the financial covenants are only tested on an 'incurrence' basis i.e. upon the occurrence of a specified event such as the borrower making an acquisition or a disposal, incurring more debt or paying a dividend.

[55] See Section I (vii) 'Events of Default', below.

[56] See M. Roberts, n.5.

borrower to create security;[57] incur further indebtedness;[58] dispose of assets[59]; return capital to shareholders;[60] enter into any merger, demerger or corporate reconstruction;[61] and make any substantial change to the general nature of the business of the borrower.[62] It is clear from the nature of these matters, that go to the ordinary course of business of the borrower, they cannot be completely prohibited, otherwise the borrower would not be able to function, consequently, each is typically subject to exceptions that seek to strike a balance between the legitimate needs of the lenders to preserve their bargain and the ability of the borrower to operate its business in the ordinary course during the term of the loan. Finding that balance will be the subject of detailed negotiations between the lenders and the borrower before the loan agreement is executed but, however carefully they are negotiated, any business, certainly a successful one, will potentially need to incur additional indebtedness, create security and enter merger discussions over the medium term, which frequently results in the terms of such covenants being renegotiated and amended or waived[63].

(vii) Events of Default

The events of default set out the circumstances in which the level of risk has changed to such an extent that the lenders have a choice either to exercise their contractual right[64] to cancel any outstanding obligation to lend; accelerate repayment of any outstanding borrowings; and/or convert the term loan to one payable 'on demand', each of which is likely to trigger severe consequences for the borrower, and possibly also the lenders, or call on the borrower to renegotiate/restructure the terms of the loan. In LMA recommended form agreements the choice rests largely with the 'majority lenders'[65] who are able to instruct the agent whether or not to exercise any of the contractual remedies available. In the event the lenders call for

[57] Referred to as the 'negative pledge' covenant, see Cl 22.3 LMA Multicurrency Term and Revolving Facilities Agreement.
[58] Cl. 28.19 LMA Senior/Mezzanine Facilities Agreement.
[59] Cl. 28.17 LMA Senior/Mezzanine Facilities Agreement.
[60] Cl. 28.21 LMA Senior/Mezzanine Facilities Agreement.
[61] Cl. 28.5 LMA Senior/Mezzanine Facilities Agreement.
[62] Cl. 28.6 LMA Senior/Mezzanine Facilities Agreement.
[63] See M. Roberts, n.5 who concludes, at p.77, "Frequent renegotiation is an integral part of bank lending. The role of renegotiation is an ex-post remedy to ex-ante restrictive contracts that grant lenders strong control rights when confronted with an information disadvantage. It is precisely because borrowers are able to renegotiate the terms of their contracts that they are willing to accept such restrictive contracts in the first place. Renegotiation is also a means to dynamically complete contracts which are inherently incomplete". See also S. Sanga, *Incomplete Contracts: An Empirical Approach*, n.6.
[64] which is probably an absolute right without any implied term fettering the decision of the lenders, see n.52.
[65] See Cl. 23.13 LMA Multicurrency Term and Revolving Facilities Agreement, which also provides that the agent may act on its own initiative.

renegotiation of the loan agreement, LMA style loan agreements specifically contemplate the manner in which amendments and waivers will be approved by them. The approach taken in the LMA Multicurrency Term and Revolving Facilities Agreement[66] is typical and requires majority lender consent to all matters other than those which are considered to be so important to require consent of all lenders, for example, changes to the margin, the date of repayment, and any increase in any commitment or its availability period[67].

II. The Importance of Privity of Contract in the Context of Complex, Dynamic and Incomplete Loan Agreements

As will be apparent from the brief description of some of the key terms set out above, LMA recommended form loan agreements are not based on the simple loan contract construction, where the lender agrees to lend a fixed amount to the borrower immediately upon the parties entering into the loan contract and the borrower agrees to repay the loan, plus interest, on an agreed repayment date. They certainly include aspects of that simple construction but also much more. They include a complex combination of rights, duties, discretions and obligations that apply to many of the core features of the loan contract which the parties bargain for, including the right of the borrower to draw down, rollover and/or re-draw the various facilities; potentially increase the amount; change the nature and/or currency of those facilities; and its obligation to comply with specific obligations at various times, for example, on each occasion it wishes to draw-down the loan, and during the entire term of the loan. Each of those rights and obligations is matched with corresponding obligations, rights and duties, which may be absolute, conditional or discretionary[68], on the part of the lenders, including: the obligation to

[66] See Cl. 35.
[67] See Cl. 35.2 LMA Multicurrency Term and Revolving Facilities Agreement.
[68] Where the rights can be asserted by way of simple decision it is largely unfettered, see *White & Carter (Councils) Ltd v McGregor* [1962] AC 413 (HL) at 430 (Lord Reid); whereas contractual discretion 'must be exercised in good faith and not arbitrarily or capriciously' (*British Telecommunications Plc v Telefónica O2 UK Ltd* [2014] UK SC 42, [2014] 4A11 ER 907 at [37] (Lord Sumption)); for a proper purpose (*Paragon Finance Plc v Nash* (2001) EWCA Civ 1466, [2002] 2 A11 ER 248); honestly and not in an arbitrary, capricious, perverse and irrational way (*Braganza v BP Shipping Ltd* [2015] UKSC 17, [2015] IWLR 1661 and *Socimer International Bank Ltd (In Liquidation) v Standard Bank London Ltd* [2008] EWCA Civ 116; [2008] Bus L.R 1304 at [66] Rix LJ); and for the proper purpose for which the discretion was given (*Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2018] EWCA Civ 355 [2018] 1 WLR 3529; and *Watson v Watchfinder.co.uk Ltd* [2017] EWHC 1275 (Comm) [2017] Bus LR 7309 [102]). It is also now arguable the proper purpose doctrine is applicable to all power, absolute and discretionary, see M. Raczynska, *Good Faith and Contract Terms* at n.16 p.86; *Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2018] EWCA Civ 355, [2018] 1 WLR 3529, and H. Sims and J. Virgo *Lenders' duties in the "twilight zone" after default but before appointment or enforcement* (2021) JIBFL 36, 534. There has also been a recent shift in the traditional English hostility towards a doctrine of good faith in the performance of 'relational contracts', see G. Leggatt, '*Negotiation in good faith: adapting to changing circumstances in contracts and English Contract Law*' [2019]

lend (potentially in different currencies and/or under different facilities) the various facilities; the right to cancel, suspend or place 'on-demand' the ability of the borrower to borrow; increase the amount and/or type of facilities made available to the borrower; accelerate the timing of repayment; increase the cost of borrowing; and waive, modify or restructure the terms of the loan agreement.

In light of that complexity, and the implicit recognition the loan contract is 'incomplete'[69] and will need to be renegotiated by the parties numerous times during its term[70], both parties will be very focussed on the identity of, and their relationship[71] with, their contracting counterparty when they negotiate the terms of their original bargain since it is each of those respective counterparties who are able to control or influence[72] the exercise of the various rights and discretions, and will be subject to the corresponding duties and obligations[73]. That focus, which has increased over recent years[74], especially from the perspective of the borrower, with the increased involvement in both the primary and secondary loan markets of so called 'shadow banks'[75], includes a clause[76] seeking to preserve privity of contract (the right to enforce rights

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Journal of Business Law 104; Yam Seng Pte Ltd v International Trade Corporation Ltd [2013] 1 Lloyds Rep 526 [153] (Leggatt J); and P. Davies *Excluding Good Faith and Restructuring Discretion*, in P. Davies and M. Raczynska (eds) *Contents of Commercial Contracts: Terms Affecting Freedoms* n.14 (at pp. 95-99), which analyses the shift towards an implied term of good faith in relational contracts. However, in the only decision to date to consider whether a loan agreement, the term of which was extended several times, is a relational contract, the argument was firmly rejected: "It was an ordinary loan facility agreement. The contractual discretions it conferred on the bank could be exercised in the bank's legitimate commercial interests but not so as to vex the borrower maliciously", *Morley (t/a Morley Estates) v Royal Bank of Scotland Plc* [2020] EWHC 88 (Ch) [159] (Kerr J) affd. [2021] EWA Civ 338. An implied duty of good faith in respect of an absolute discretion to accept less than full repayment on the repayment date of a loan agreement (the balance to be repaid later), which "had been drawn up with legal assistance between experienced commercial parties" was also rejected by the Court in *Sibner Capital Ltd v Jarvis and another* [2022] EWCH 3273 (Ch), at [34].

[69] See S. Sanga, n.6 and M. Roberts n.5.

[70] See M. Roberts, n.5. whose findings indicate such renegotiations are more commonly initiated by borrowers and focus on contract modifications to pricing, maturity, amount and covenants. See also Hart and Moore, *Default and Renegotiation: a dynamic model of debt*, Quarterly Journal of Economics, 113 (1998), 1-42.

[71] For an interesting discussion on the importance of 'relationship' lending from the perspective of the borrower, see n.8.

[72] In a syndicated loan this will be subject to the value of each lender's commitment in the loan and the extent to which that enables them to satisfy the 'majority lender' definition and thereby be in a position to instruct the Agent to take a particular course of action, or potentially block other lenders from doing that, if a lender holds more than $33^{1}/_{3}$, thereby preventing a majority lender direction.

[73] For an interesting analysis of some of these issues in the context of consumer loans see: S Shiffrin, *Hidden Delegations: The Assignment of Contractual Rights and Consumer Debt*, (2023) 86 (1) MLR 1, 14-17.

[74] Especially since the 2007-2009 Global Finance Crisis, following which the lending capacity of regulated banks was significantly reduced and that of the so-called 'shadow banking' sector, in both the primary and secondary loan markets, significantly increased, see R.Irani, R.Iyer, R.Meisenzahl and J-L Peydro, *The Rise of Shadow Banking:Evidence from Capital Regulation*, The Review of Financial Studies 34 [5] (2021) 2181.

[75] See G. Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* n.80 at pp 91-92.

[76] Cl. 1.4 LMA Multicurrency Term and Revolving Facilities Agreement.

and obligations arising under a contract) between the contracting parties[77] to the loan agreement by expressly excluding the CRTPA completely, with the effect that the privity doctrine will continue to apply to the contract and the rights of third parties will continue to be governed by the common law rules and techniques that have been developed to enable a person who is not a party to a contract to enforce its terms. Enforcement for these purposes includes all the remedies that would have been available to the third party had she been a party to the original loan contract.

The doctrine of privity is subject to many exceptions[78], two of which are relied on in the 'changes to the lenders' clause[79] which is included in LMA recommended form loan agreements to extend privity to a limited category of 'new lenders'. That clause, which is typically the subject of detailed negotiation between the parties[80], sets out the procedure and conditions applicable to the assignment of a lender's rights or the transfer, by way of novation[81], of a lender's rights and obligations, in the various facilities made available to the borrower. The most important feature of those conditions, for the purpose of this article, is the requirement for the borrower's consent to be given[82] unless the assignment or transfer is to a restricted class of permitted assignees and transferees. Strong investment grade borrowers will seek to limit that class solely to existing lenders and their affiliates or to lenders with a minimum credit rating[83], but in the leveraged loan market it is typically extended to include a

[77] The clause extends privity to new lenders who become lenders under the loan agreement pursuant to either an assignment or a transfer by way of novation carried out in accordance with the *'Changes to the Lenders'* clause, see section IV (iv) 'Elevation of the Sub-Participant's Economic Interest in the Loan to a Legal or Equitable Interest', below, and Cl. 24 LMA Multicurrency Term and Revolving Facilities Agreement.

[78] See E. Peel, *Treitel The Law of Contract,* n.1, [14-086 - 14-146]; and H. Beale ed., *Chitty on Contracts*, (34th ed. Sweet & Maxwell 2022) Ch. 18.

[79] See Cl. 24 LMA Multicurrency and Revolving Facilities Agreement and Cl. 30 LMA Senior/Mezzanine Facilities Agreement.

[80] See *The ACT Guide* n.8, Section 9: *Changes to the Parties* pp. 295-308; G. Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* (2022) 37 JIBLR 3, 85 at pp 99-102; and *The new breed of transfer restrictions in leveraged lending transactions: a new paradigm or just a sign of the times* (2018) 4 JIBFL 222.

[81] For an analysis of the 'standing offer' technique typically included in English law governed term loan agreements to facilitate transfer by way of novation see M. Hughes, '*Transfer Ability in Syndicated Lending'*, Law and Financial Markets Review [2007] 21. The veracity of the technique was confirmed in *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd* [2010] EWCA Civ 1335.

[82] The borrower's consent must not be unreasonably withheld or delayed, Cl. 24.2(b) LMA Multicurrency Term and Revolving Facilities Agreement, see *Habibsons Bank Ltd v Standard Chartered Bank (Hong Kong) Ltd* n.81, *Barclays Bank plc v Unicredit Bank AG & Anor* [2012] EWHC 3655 Comm; [2014] EWCA Civ 302; and *Argo Fund Ltd v Essar Steel Ltd* [2006] EWCA Civ 241.

[83] Such an approach may be considered important by a borrower if, for example, the loan agreement includes a revolving facility or other ongoing lending obligations. For a more general discussion of the importance of this clause see *The ACT Guide* n.8 pp. 295-307.

pre-approved lender list, often referred to as a 'white list'[84], of named entities to which a lender may transfer or assign all or part of its commitment in the loan. LMA style loan agreements also typically disapply the consent right of the borrower following an event of default under the loan agreement that is continuing[85]. As we shall see, it is the unfettered right of the lenders to transfer or assign the loan following an event of default that, together with the transfer of voting rights in the underlying loan[86], undermines privity of contract between the lenders and the borrower and potentially establishes privity between the borrower and the sub-participant.

Any assignee or transferee which acquires a legal or equitable interest in the loan by virtue of the procedure set out in the '*changes to the lenders*' clause[87] will become a lender of record under the loan agreement, enjoy full privity of contract with the borrower, and be able to exercise all the rights, powers and discretions (in the case of a transfer by way of assignment), and also be subject to all the obligations (in the case of a transfer by way of novation), of the original lender, including the obligation to make further advances that are available to the borrower under the loan.

LMA recommended form loan agreements ensure privity is maintained with the borrower throughout the entire term of the loan contract by the inclusion of a general prohibition on the assignment or transfer by the borrower of any of its rights or obligations under the loan agreement[88].

III. The Original Form and Legal Characterisation of Sub-Participation

The original form of English law governed sub-participation agreement was developed in the late 1970's and was based on a form of contract known as a 'participation' that had been used

[84] An alternative to the 'white list', that is also commonly used, is a prohibited lender list, often referred to as a 'black list', specifying the entities to which the underlying loan may not be transferred and/or identifying types of identities which are prohibited, for example, 'vulture funds' or 'buyers of distressed assets', however, recent case law has highlighted significant risks with this approach, see *Grant v WDW3 Investments Ltd* [2017] EWHC 2807 (Ch) and *Argo Fund Ltd v Essar Steel Ltd*, n.82.
[85] Although strong, investment grade borrowers often resist the inclusion of such a provision, see *The ACT Guide* n.8 at p.298.
[86] See Section IV (iii) below.
[87] See n.77.
[88] Cl 25.1 LMA Term and Revolving Facilities Agreement.

in the US for many years[89]. That form was very familiar to the relatively small number of large, primarily US, banks which dominated the European primary term loan market at the time. Those banks enjoyed a near monopoly over lending relationships with the strongest, investment grade, European corporate borrowers that were able to access the primary term loan market at that time. However, although those banks were willing to allow other banks[90] to share in the risk and reward of their prized lending relationships, they did not wish to do that in a way that might jeopardise those relationships and their dominance of the primary term loan market. That required a different approach because US style participation agreements, typically entered into under New York law, transferred to the sub-participant a beneficial interest in the loan or its proceeds[91]. Some cases characterised the interest as a partial assignment[92], others as a trust over the loan or its proceeds[93] but, crucially, in all cases it was recognised the agreement created an interest in the underlying loan and/or its proceeds in favour of the sub-participant and privity of contract with the borrower. That was not the intention of the banks which dominated the European primary term loan market at the time; their intention was to transfer only an economic interest in the loan and its proceeds, not one that gave the sub-participant any legal or beneficial interest and certainly not one that gave the sub-participant privity with the borrower. Their objective was achieved by the lender (typically referred to as the 'grantor' of the sub-participation) and the sub-participant entering into an entirely separate 'back-to-back' contract which, although linked to the underling loan and its proceeds, was legally and beneficially independent. Early forms of the agreement were remarkably simple; the sub-participant placed a deposit, essentially representing a back-to-back loan, with the lender, in an amount equal to all or part of its participation in the underlying loan, and the lender agreed to pay the sub-participant amounts equal to the participant's share of the amounts representing principal and

[89] See Hutchins, *What Exactly is a Loan Participation?* 9 Rut-Cam LJ. 447 (1978); Szathmary, *The Participation Agreement as a Fundraising Vehicle*, 3(i) International Business. L. 75 (1975); and Armstrong, *The Developing Law of Participation Agreements*, 50J. Com. Bank Lending 45 (1968).

[90] See A. Armstrong, *The Developing Law of Participation Agreements* (1998) 23(3) Bus. Law 689; and E. Behrens, *Classification of Loan Participations following the Insolvency of a Lead Bank* (1984) 62 Texas Law Review 1115. At the time buyers in the secondary loan market were primarily banks, that has now changed, see G. Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* n.80 at pp 91-92.

[91] Some commentators questioned the legal characterisation of US style participation agreements but by the late 1970's it was fairly well settled that the form of agreement, typically entered into under New York law transferred a beneficial interest in the loan or its proceeds to the sub-participant. See A. Armstrong and E. Behrens n.90; Desjardins, *Assignments and Sub-Participation Agreements – A Basic Overview* [1986]. The Canadian Bar Review 224; and D.L. Threedy, *Loan Participations – Sales or Loans? Or Is That The Question?* (1989) 68 OR.L.Rev 649.

[92] In *Re Westover Inc*. 82 F 2d 177 (2d Cir.1936).

[93] See *Stratford Financial Corp v Finex Corp* 367 F 2d 569 (2d Cir.1966) and Re Alda Commercial Corp 327 F. Supp, 1315 (SNDY 1971). For an interesting analysis of the characterisation of US style participation see D. Simpson, *Loan Participation: Pitfalls for Participants* (1976) 31 The Business Lawyer 4.

interest received by the lender from the borrower if and when those amounts were received. This back-to-back loan between the sub-participant and the lender became known as a "funded[94] sub-participation" because the contract between the sub-participant and the lender was typically 'fully funded' in an amount equal to the sub-participant's participation in the underlying loan.

The sub-participation agreement originally developed created a purely contractual relationship between the lender and the sub-participant and the nature of their relationship was that of debtor and creditor. No relationship, either direct or indirect, was intended to be created between the sub-participant and the borrower. As one commentator noted at the time, "it would be unusual for the [sub-] participant to be given any right to direct the [lender] how to vote at syndicate meetings or otherwise participate indirectly in the administration and running of the loan. The [lender] would normally retain sole discretion in those areas"[95]. The sub-participation was intended to mimic the economic effect of the underlying loan by means of an entirely independent contract which gave no rights, either now or in the future, in the underlying loan. It was a classic derivative contract whose value was derived entirely from the underlying loan but which neither created nor transferred any interest in that loan.

One important aspect of sub-participation agreements, which was established at inception and distinguished them from many other types of derivative contract, was the requirement for the lender to own the reference asset, the underlying loan, upon which the derivative sub-participation contract was based. That requirement ensured sub-participations were created only in respect of loans held 'on balance sheet' by the lender and prevented sub-participations being used to create a synthetic exposure in a loan that could be used for purely arbitrage purposes. Comprehensive representations relating to ownership and 'no impairment' of the underlying loan were included in the earliest forms of sub-participation agreement[96]. Those now typically extend to all forms of claim impairment, default, alienability, bad acts, rights of

[94] An alternate form of 'risk participation' was developed later by the market in which the sub-participant did not fund advances made by the lender at the time they were originally made but rather provided the lender with a guarantee or indemnity which could be called on by the lender in the event the borrower failed to make payments of interest or repay principal when due.
[95] Norton, Rose, Botterell & Roche, *Selling Loan Assets under English law: a basic guide* IFLR (May 1986) 26, at p.28.
[96] See G. Penn, A. Shea and A. Arora, *The Law and Practice of International Banking* (1987, Sweet & Maxwell) Ch.8.

set off, funding obligations, litigation and extensive 'predecessor – in-title' representations[97], often tracing ownership to the origination of the underlying loan in circumstances where the lender/grantor is not the original lender of the loan. It is the ongoing ownership by the lender of the underlying loan, and the various rights, duties, discretions and obligations, vis-à-vis the borrower, to which that ownership gives rise, that is at the core of many of the issues raised in this article.

The original form of sub-participation agreement not only achieved the legal and commercial objectives of banks which dominated the primary term loan market at the time, it also achieved the desired bank regulatory treatment by enabling the lender to remove the relevant participation in the underlying loan from its balance sheet for regulatory capital purposes[98]. That exposure was transferred to the sub-participant and included in its regulatory balance sheet as a claim on the borrower.

The characterisation of the original form of funded sub-participation as "a separate legal agreement from the underlying loan, which creates a debtor-creditor relationship between [the lender] and [the sub-participant] in which the sub-participant does not (or at least is not intended to) acquire any legal or beneficial interest in the loan, nor any contractual relationship with the underlying borrower" was also recognised by the lead bank regulator (the Bank of England) at the time[99]. That characterisation was also recognised by the Privy Council in one of the few English law cases on sub-participation[100]. Although the underlying transaction in which the sub-participation was created in that case was a note issue, rather than a loan, the form of the agreement, which was entered into in 1996, was consistent with the approach initially adopted by the market. Clause 2 of the sub-participation agreement, which the Privy Council considered to be the main operative clause, stated "The relationship between [the noteholder] and the [sub-] participant thus arising shall be a debtor-creditor relationship. The [sub-] participant shall have no rights of ownership in the subject notes nor does [the noteholder] act as agent or trustee for the [sub-] participant; provided that [the noteholder] shall not be entitled to sell or otherwise dispose of the subject notes, without the prior written consent

[97] LMA Secondary Debt Trading Documentation (Par and Distressed) Users Guide (30 March 2022) Condition 22 at pp 68-77.
[98] The Bank of England confirmed this as early as 1987, see Bank of England, Banking Supervision Division, Notice to Institutions Authorised under the Banking Act 1987: Loan Transfers and Securitisation BSD/1989/1.
[99] Bank of England Consultative Paper, Notice to Institutions Authorised under the Banking Act 1987: Loan Transfers and Securitisation BSD/1989/1.
[100] *Lloyds TSB Bank Plc v Clarke* [2002] UKPC 27.

of the [sub-] participant"[101]. In distinguishing a sub-participation from an assignment or a trust, the Privy Council focussed on the source of funds from which the sub-participant was to be paid. The obligation of the lender to pay the sub-participant was triggered only when the borrower made a payment of principal or interest on the underlying notes, however, that payment was only the measure of the payment to be made to the sub-participant, not the source of that payment: "[the lender] shall remit to the [sub-] participant such amount…such amount being equal to the amount so received or recovered by [the lender][102]. That wording established the arrangements "as being a sub-participation as commonly understood and established a classic debtor-creditor relationship without giving the [sub-participant][103] any interest in the underlying loan"[104]; no privity of contract with the borrower and, therefore, no ability to enforce or obtain the benefit of any of the terms in the underlying loan agreement.

The effectiveness of the original form of sub-participation agreement in protecting the relationship and maintaining privity of contract between the lender and the borrower[105], by ensuring the sub-participant obtained no rights over the underlying loan which might prejudice that relationship, resulted in sub-participation quickly becoming the preferred method of transfer in the secondary loan market[106]. That preference has increased over the years, largely because of tighter restrictions being included in LMA style loan agreements on the lender's ability to transfer loans by way of novation or assignment[107]. Since the original form of sub-participation created only an economic interest in favour of the sub-participant and no rights in favour of the sub-participant over the underlying loan, no privity of contract between the sub-participant and the borrower, it was largely ignored by borrowers in the context of the transfer restrictions they sought to include in loan agreements[108].

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[101] *Lloyds TSB Bank Plc v Clarke* n.100 at [25].
[102] *Lloyds TSB Bank Plc v Clarke* n.100 at [22].
[103] *Lloyds TSB Bank Plc v Clarke* n.100 at [25].
[104] *Lloyds TSB Bank Plc v Clarke* n.100 at [17].
[105] This principle was confirmed in a very recent case involving a sub-participation agreement which was not based on an LMA recommended form but rather the Bankers Association for Finance and Trade standard form. In that case S.Houseman KC (sitting as a judge in the High Court) stated "a [sub] participation sits outside the primary structure in a way that transfers economic impact without involving legal privity with the primary obligor", *Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Ltd* [2023] EWHC 1212 (Comm) at [1].
[106] Another important factor was the effectiveness of funded sub-participations in achieving complete regulatory capital carrying cost relief for the lender by enabling it to remove the loan from its balance sheet for regulatory capital purposes, see Bank of England Consultative Paper, *Notice to Institutions Authorised under the Banking Act 1987: Loan Transfers and Securitisation*, BSD 1 (1987).
[107] See section II.
[108] That may now be changing as a consequence of changes made to LMA recommended form sub-participation agreements, see F. Khan, T. Gausel, T. Mann and D. Neale, *Transfer Restrictions in Leveraged Lending Transactions: time for a re-assessment*, JIBFL 4 (2022) 251; and The ACT Guide n.8, at p 302. On the

IV. Changes to the Form and Legal Substance of Sub-Participation

The various forms of sub-participation currently used in the secondary loan market are almost unrecognisable from the form of agreement originally developed. As with the primary loan market the forms currently used are typically based on one of the recommended form agreements produced by the LMA and, for the purpose of describing the key changes that have been made, this article will focus on the LMA Funded Participation (Par/Distressed) agreement, issued 4 January 2022 (the "LMA Funded Participation Agreement"); the LMA Multilateral Termination and Transfer Agreement (Bank Debt/Novation) issued 3 March 2014 (the "LMA Multilateral Termination and Transfer Agreement"); the LMA Bilateral Termination and Transfer Agreement (Bank Debt/Novation) issued 14 May 2012 (the "LMA Bilateral Termination and Transfer Agreement"); and the LMA Termination Agreement issued 14 May 2012, although reference will also be made to some of the LMA's other recommended form sub-participation agreements.

(i) The Funding Obligation of the Sub-Participant

Consistent with the original approach, the LMA Funded Participation Agreement deals with commitments in the underlying loan facilities which have already been drawn by the borrower by means of a funded back-to-back loan between the lender and the sub-participant. However, it also covers undrawn commitments of the lender, for example, under a revolving loan facility or, as previously mentioned, one of the ancillary facilities the lender has agreed to make available to the borrower as part of its overall commitment under a revolving facility. In classic back-to-back funding style, whenever the borrower delivers a utilisation request to draw down one of the facilities that have been sub-participated, the sub-participant is required to put the lender in funds, to 'fund' the sub-participation, in advance of the lender funding its commitment to the borrower under the loan[109]. The Agreement also contemplates the lender requiring the sub-participant to collateralise its obligations to fund undrawn commitments[110] thereby removing the lenders credit risk on the sub-participant.

development of transfer restrictions and their potential impact on sub-participation, see Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* n.80, at p99.

[109] See Cl. 2 LMA Funded Participation Agreement.

[110] Cl. 9 LMA Funded Participation Agreement.

(ii) The Sub-participant Assumes the Risk of Restructuring

The LMA Funded Participation makes clear any amendment or waiver of the underlying loan agreement; any refinancing of the loan facilities; and any restructuring of the indebtedness approved by more than 50% of the relevant creditors, will be binding on the sub-participant[111]. However, the sub-participant is not obliged to fund any increase in the underlying loan facilities agreed by the lender unless it agrees to do so[112]. This risk is significant in the context of control over voting rights in the underlying loan to which we will now turn.

(iii) Control Over Voting Rights in the Underlying Loan Agreement

As previously mentioned,[113] the original form of sub-participation gave the sub-participant no rights of control, direct or indirect, over the underlying loan to protect its economic interest, such rights were typically retained and exercised at the sole discretion of the lender. The absence of such rights, including the ability, indirectly, to control enforcement action against the borrower, was recognised as an early potential problem by both the secondary loan market and the increasingly important securitisation market[114] in which regulated banks initially used sub-participation as the preferred method to transfer corporate loans to special purpose issuing vehicles (typically referred to as 'SPVs')[115]. The concerns were highlighted in the 'risk factors' included in such transactions, which referred to the lack of privity between the sub-participant (the SPV issuer) and the borrowers of the underlying loans, specifically in the context of the inability of the sub-participant to influence or control the exercise of any voting rights in connection with any enforcement action or waiver following an event of default. The risk of the lender potentially having interests which may be different from, and possibly in conflict with, those of the SPV sub-participant, and not being required to take the interests of the latter into account, were also highlighted. Some early forms of sub-participation did provide limited protection to the sub-participant in respect of material amendments or waivers, for example, to

[111] Cl. 10 LMA Funded Participation Agreement.
[112] Cl. 10.5 LMA Funded Participation Agreement.
[113] See section III above.
[114] See Penn, *Promoting Liquidity in the Secondary Loan Market : Is Sub-Participation Still Fit for Purpose?* n. 80, at pp89-90 which makes reference to some of the earliest securitisation transactions that used sub-participation to 'transfer' the underlying portfolio of corporate loans to the SPV issuer.
[115] The early 'Rose funding' securitisation transactions originated by NatWest Bank are good examples, see Penn, *'Promoting Liquidity in the Secondary Loan Market : Is Sub-Participation Still Fit for Purpose?'* n.80, at pp89-90.

postpone or reduce payments of principal or interest, extending the maturity or releasing security, but those protections rarely required consent from the sub-participant[116]. That relatively benign approach to control over voting and enforcement rights started to change in the mid-1990's when distressed loans were increasingly bought and sold in the secondary loan market[117]. The buyers of such loans, which increasingly included specialist debt traders and so-called 'vulture funds', often focussed on a different business strategy to that of the lender in order to extract value from the loan. That strategy typically included a more aggressive approach to the enforcement of the lender's rights and the exercise of its discretions under the loan agreement and, to achieve the desired objectives, required control by the sub-participant over the exercise of those rights and discretions. The extent of that control has increased over the years[118] and is now included in Clause 6.2 of the LMA Funded Participation Agreement which contemplates, in the context of a 'distressed trade'[119] sub-participation, extensive "voting rights"[120] being granted to the sub-participant. However, since the sub-participant enjoys no proprietary interest in, or rights over, the underlying loan and no contractual relationship with, or any rights in respect of, the borrower[121], it is not possible for such voting rights to be exercised directly by the sub-participatant, they can only be exercised indirectly, via the lender, which acts as an undisclosed intermediary between the sub-participant and the borrower. Where voting rights are transferred to the sub-participant under the LMA Funded Participation Agreement the sub-participant enjoys complete[122] indirect control over all the rights and discretions of the lender who is not able to exercise or refrain from exercising **any** of its rights under the loan agreement; agree **any** variation or waiver; or perform **any** actions, without the prior consent of the sub-participant[123]. Conversely, if the Funded Participation Agreement

[116] In the case of the Rose Funding securitisation transactions, see n.80, the lender (NatWest Bank) was required to first obtain a 'no-downgrade' confirmation from the rating agencies which rated the bonds issued by Rose Funding, no consent was required from the sub-participant (the SPV Issuer – Rose Funding Plc).
[117] LMA, *Guide To Secondary Loan Market Transactions* (August 2018) p7. See also N. Voisey and A. Slocombe (eds), *The Loan Book : The Syndicated Loan Market Through the Credit Crisis of 2007-2009 and the Consequences and Challenges for the Future*, n.3 Chap's 2-3.
[118] This trend has also been followed in relation to other more conventional derivative instruments, including total return swaps, credit default swaps and credit insurance, which increasingly require lenders to transfer voting and subrogation rights (and sometimes physical settlement of the underlying loan asset following an event of default) to the protection seller/credit insurance provider, see F. Khan, T. Gansel, T. Mann and D. Neale, *Transfer restrictions in leveraged lending transactions: time for a re-assessment* (2022) 4 JIBFL 251.
[119] A 'distressed trade' is simply one designated as such by the parties before they enter into the sub-participation agreement. See LMA 'Secondary Debt Trading Documentation (Par and Distressed) Users Guide' (30 March 2022), S.5.4.
[120] See Cl. 6.2(b) LMA Funded Participation Agreement.
[121] This is confirmed in the 'Status of the Participation', see Cl. 6.1 LMA Funded Participation Agreement.
[122] Assuming the sub-participation relates to the entire commitment of the lender, see n.130.
[122] 15 F.3d 238 (2d Cir.1994).
[123] Cl. 6.2 LMA Funded Participation Agreement.

states that if no voting rights are granted to the sub-participant, the lender may continue to exercise or refrain from exercising **any** of its rights, agree **any** variation or waiver; or perform **any** acts, under the loan agreement as it deems fit without any responsibility to the sub-participant who, therefore, enjoys no indirect control over the underlying loan. Although the LMA Funded Participation contemplates voting rights being granted only in respect of a 'distressed trade', its 'User's Guide' recognises such rights may also be granted where the sub-participation relates to a 'par trade'[124]. As an alternative to granting full control over all voting rights to the sub-participant, the LMA Funded Participation Agreement contemplates, in the case of a par trade of all the lender's commitment (both drawn and undrawn) in the loan, control being given to the sub-participant in respect of key decisions; namely any variation to the term, amount or currency of any of the facilities, any reduction in the interest or fees payable, any release of security or guarantees, and any amendment or waiver which requires the consent of all lenders under the loan agreement. The prior written consent of the sub-participant is required for each of those decisions[125]. Similar provisions were included in the sub-participation agreement in the recent case of *Yieldpoint Stable Value Fund LP v Kimura Commodity Trade Finance Fund Limited* [126] where the agreement was not based on an LMA recommended form but rather the Bankers Association for Finance and Trade recommended form[127].

The LMA Funded Participation Agreement also imposes a general duty of care on the lender with regard to its obligations under the loan agreement which it is required to comply with "in a timely manner……and exercise the same degree of care with regard to the [sub-participant's portion of the commitment] as it would if it had not entered into the [sub-participation]"[128].

The 'granting' of voting rights to the sub-participant and the requirement that the lender obtain its prior written consent before exercising (or refraining from exercising) any of the lenders' rights under the loan agreement creates potentially significant problems in respect of both the legal and commercial relationship between the lender and the borrower. Those parties may technically continue to enjoy privity of contract but there will be no substance to that privity. The lender may formally continue to exercise, or refrain from exercising, the various rights,

[124] LMA Secondary Debt Trading Documentation Users Guide (30 March 2022) s.8.3(h)(ii) p.104.
[125] Cl. 6.2(d) LMA Funded Participation Agreement.
[126] [2023] EWHC 1212 (Comm)
[127] *Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Ltd* [2023] EWHC 1212 (Comm) at [20].
[128] Cl. 6.3 LMA Funded Participation Agreement.

powers and discretions under the loan agreement referred to in section 1 of this article but effective control over the exercise of those rights will rest with the sub-participant, upon whose instructions the lender will be required to act. This raises some interesting questions about the purpose for which the rights and discretions are granted to a lender in the context of a complex, dynamic and incomplete term loan agreement which are beyond the scope of this article. The exercise of those rights and discretions may be "rationally connected to [the lender's] commercial interests"[129], but did the original parties, particularly the borrower, who bargained for extensive restrictions to be imposed on the ability of a third party to exercise them, intend the purpose to include exercising them at the direction and under the control of an unknown sub-participant in order to protect her economic interest?

The 'granting' of voting rights also raises serious issues for the borrower in the context of the bargained for terms it agreed with the lender, because it will not typically be aware a sub-participation has been entered into, sub-participations are rarely disclosed, so the instructions of the sub-participant will be implemented in circumstances where the borrower is unaware the lender, possibly a relationship lender, is acting under the direction and control of an undisclosed third party[130]. Such an arrangement mirrors many of the elements of the doctrine of undisclosed principal[131] which is well established within English law[132] notwithstanding it is regarded by many as anomalous[133] and offensive "against many contractual principles, including (most notably) the principle of privity of contract"[134]. The doctrine, which is recognised as another exception to the privity doctrine[135], allows an undisclosed principal to take the benefit and be subject to the obligations of a contract which was entered into by an agent, acting on the authority of the principal, and a third party who, being unaware of the principal's involvement, dealt with the agent as principal to the contract. Such a construction was applied to various

[129] per Kerr J at first instance, *Morley (t/a Morley Estates) v Royal Bank of Scotland Plc* n.52.
[130] If the lender's commitment under the loan has been sub-participated to more than one sub-participant, the sub-participation agreement will typically include a voting mechanism in respect of the control and direction given to the lender by the various sub-participants to whom it has transferred a fractional interest in its commitment.
[131] Also referred as the doctrine of undisclosed agency.
[132] *Sin Yin Kwan v Eastern Insurance Co Ltd* [1924] 2 AC 199; see also Tan Cheng-Han, *Undisclosed Principles and Contract* (2004) 120 LQR 480; and A. Goodhart and C. Hamson, '*Undisclosed Principals in Contract*' (1932) 4 CLJ 320.
[133] See P. Watts, *Bowstead and Reynolds on Agency* (Sweet & Maxwell, 22nd ed. 2022) Ch. 8; E. Peel, *Treitel's Law of Contract* (Sweet & Maxwell, 15th ed. 2020) 16-065; and Tan Cheng-Han n.132.
[134] *Family Food Court v Seah Boon Lock* [2008] 4 SLR (R) 272 at [29] cited in Tan Cheng-Han, *Implied Terms in Undisclosed Agency* (2021) 84(3) MLR 532.
[135] The independent rights of the undisclosed principal have been said to be established in the interests of commercial convenience, *Siu Yin Kwan v Eastern Insurance Co Ltd*, n.132 at 207.

English law governed sub-participation agreements by the US Court of Appeals, Second Circuit, in *Commercial Bank of Kuwait v Rafidain Bank and Commercial Bank of Iraq*.[136] In that case the court held the syndicate lenders had entered into the syndicated loan agreements with the Iraqi banks as undisclosed agents of the sub-participants. The US Court of Appeals found it "hard to believe the Iraqi banks [the borrowers] did not know the syndicated loans were the subject of sub-participation agreements and that they, as borrowers, were potentially liable to the sub-participants (as principals). Such sub-participations are common practice". The judgement makes no reference to the terms typically included in English law governed sub-participation agreements, which expressly exclude the lender acting as agent, trustee or custodian for the sub-participant[137], nor does the court appear to have considered the significance of the syndicated loans being entered into some time before the sub-participations. As we have already seen[138], the LMA Funded Participation does contemplate the lender entering a sub-participation before some (potentially all) of the facilities are fully drawn down by the borrower and, in such cases, the sub-participant is required to fund the lender its participation prior to any such drawdown[139]. In the event the lender enters into such a sub-participation prior to, or contemporaneously with, the execution of the loan, the arrangement would be more akin to an undisclosed agency, especially where the lender consults with, and takes directions from, the sub-participant on the terms of the loan it negotiates with the borrower. However, no such arrangement was in place in the *Commercial Bank of Kuwait* case [140]; the syndicated loans were executed and drawn down by the borrowers prior to the sub-participation agreement being entered into so no undisclosed agency existed at that time. The Privy Council made no reference to the decision of the US Court of Appeals in the leading English law case[141] on sub-participations and, based on the facts of the case, in particular the syndicated loans being entered into some time before the sub-participations, its construction is unlikely to be followed by the English courts. However, the conceptual basis upon which the doctrine of undisclosed principal is justified may, in light of the changes that have been made to the form and legal substance of sub-participation, be appropriate to apply to sub-participation and we shall consider that later in this article.

[136] 15 F. 3d 238 (2d Cir.1994).
[137] This is now included in the clause setting out the status of the participation in the underlying loan, see Cl. 6.1(c) LMA Funded Participation Agreement.
[138] See section IV(i).
[139] That funding obligation relates to the 'back-to-back' loan between the sub-participant and the lender, see section IV(i).
[140] *Commercial Bank of Kuwait v Rafidain Bank and Central Bank of Iraq*, n.136.
[141] *Lloyds TSB Bank Plc v Clarke* n.100.

(iv) Elevation of the Sub-Participant's Economic Interest in the Loan to a Legal or Equitable Interest

Another significant change to the original form of sub-participation which has potentially far-reaching effect on its commercial nature and legal effect, particularly in the context of its impact on privity of contract between the lender and borrower, and, potentially, the borrower and the sub-participant, is the inclusion in the LMA Funded Participation Agreement of a provision known as 'elevation'[142]. As its name suggests, this mechanism contemplates the future 'elevation' of the sub-participant's status to that of lender of record in the underlying loan in respect of the sub-participant's commitment in that loan. Since any such elevation would be subject to the restrictions on transfer without borrower consent typically included in LMA style loan agreements and referred to earlier[143], the LMA Funded Participation Agreement contemplates an alternative mechanism if those restrictions extend to the sub-participant and prevent it becoming a lender of record. In such a situation the sub-participant can require the lender's interest in the underlying loan be transferred to a third party, which is not caught by the restrictions, and which will become a lender of record. In such a case the sub-participant will also enter into a new back-to-back sub-participation with that third party in order to maintain its economic interest in the loan[144].

The elevation mechanism is expressed to be available "on request" by either the sub-participant or the lender. The relevant clause[145] provides that "subject to the terms……of [the underlying loan agreement]……upon the request of either party, each party shall use its commercially reasonable efforts to, as soon as reasonably practicable……cause the [sub-] participant (or [a third party as] directed by the [sub-] participant) to become a Lender under the [underlying loan agreement in respect of any sub-participated commitment]"[146]. The proviso, limiting elevation by reference to terms in the underlying loan agreement, recognises one of the main drivers for its use is because sub-participation is not typically caught by the transfer restrictions included in LMA style loan agreements, including the need to obtain borrower consent. Lender

[142] The elevation mechanism is set out in Cl. 19 of the LMA Funded Participation Agreement.
[143] See section II.
[144] Such a transfer to a third party would also mitigate the sub-participant's double credit risk on the original lender of record and is sometimes used for that purpose, see G. Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* n.80 at pp.96-99.
[145] See Clause 19.1 LMA Funded Participation Agreement.
[146] ibid.

transfer restrictions typically focus only on transfers by way of novation and assignment[147], because it is only a transfer by one of those methods that enable a third party to become a lender of record, and thereby enjoy all the rights, powers and discretions and, in the case of a transfer by way of novation, be subject to the various obligations, of a lender under the loan agreement. As we have seen, those transfer restrictions typically disapply any borrower consent requirement for transfers by way of both novation or assignment[148] following an event of default[149]. The result is an undermining of privity of contract between the borrower and the lender, and the contingent creation of privity between the sub-participant and the borrower, immediately upon the sub-participation being entered into. This is because, even if borrower consent restrictions apply to the sub-participant at that time, either the sub-participant or the lender can, at any time, require the lender's interest in the loan be transferred by means of assignment or novation to a third party lender, which is not caught by the restrictions, and because those restrictions cease to apply immediately upon the occurrence of an event of default, the sub-participant will, upon such an occurrence, have an unfettered right to terminate its economic interest in the loan[150] and replace it with a legal or equitable interest, either of which create privity with the borrower. Initially that privity will be established only in respect of the sub-participated commitment in the underlying loan, however, the consequences are potentially far more significant for the borrower because once a sub-participant is 'elevated', and thereby becomes a lender of record, no further borrower consent restrictions will typically apply to its capacity as a new lender to acquire further interests in the loan, either by way of novation or assignment. As we have seen[151], there is no requirement to obtain borrower consent for transfers to "existing lenders" which the sub-participant will become following its elevation to the status of lender of record. Consequently, elevation of a relatively modest (by value) sub-

[147] See section II.

[148] Assignment and novation are the only such methods of transfer that will enable the sub-participant to become a 'lender' (of record) as defined under LMA recommended form loan agreements, see section II. See also Cl. 25 LMA Multicurrency Term and Revolving Facilities Agreement and Cl. 30 LMA Senior/Mezzanine Facilities Agreement.

[149] The definition of an event of default for these purposes is very broad and captures technical as well as credit related matters, see, Cl. 23 LMA Multicurrency Term and Revolving Facilities Agreement. This exposes borrowers to the risk that a previously restricted sub-participant will be elevated to a lender of record under the relevant loan upon the occurrence of a relatively minor default. A borrower might be concerned at the prospect of its lender[s] changing at such a time, particularly if the lender 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. A similar provision is increasingly included in other more conventional forms of derivative contracts, including total return swaps and credit default swaps, which require physical settlement (transfer) of the underlying loan asset following an event of default, n.118.

[150] Which may at that time be held via either the original lender or a third party who has become the lender of record.

[151] See section II.

participation, which potentially gives the sub-participant only limited control over the underlying loan[152], will, nevertheless, expose a borrower to unrestricted transfers by way of novation or assignment to the same sub-participant thereby potentially enabling that party to acquire either a negative control 'blocking' position[153] or direct control[154] over all the rights, powers, discretions and, in the case of transfers by way of novation, obligations in the underlying loan agreement[155].

The elevation mechanism included in LMA style participation agreements does not automatically convert the sub-participation into a transfer of the participated commitment by way of novation or assignment immediately upon the relevant contingency being satisfied. Rather it terminates[156] the sub-participation agreement and replaces it with a direct legal or equitable interest in the relevant commitment in the underlying loan[157]. This is achieved by the execution of either a 'Bilateral Termination and Transfer Agreement', in circumstances where the sub-participant is to become the lender of record, or a 'Multilateral Termination and Transfer Agreement' where it is proposed that a third party will become such a lender. The former will typically be entered into when there are no restrictions in the underlying loan preventing the sub-participant immediately becoming the lender of record, or such restrictions no longer apply because, for example, an event of default has occurred.[158] The Multilateral Termination and Transfer Agreement will typically be used where such restrictions continue to prevent the sub-participant becoming the lender of record, in such cases the sub-participant and the third party will also enter into a new sub-participation agreement thereby enabling the sub-participant to maintain its economic interest in the loan. The terms of that new agreement may be materially different from those included in the original (now terminated) sub-participation agreement and may, for example, give the sub-participant greater voting and

[152] This is because of the 'majority lender' voting provisions included in LMA form loan agreements; however, it will enable the sub-participant to block any issues on which unanimity is required, see n.72.
[153] Typically set at any holding (in aggregate) exceeding $33^{1}/_{3}$% of the total outstanding commitments in LMA recommended form loan agreements, which enables a party to block a "Majority Lender" decision.
[154] Typically set at $66^{2}/_{3}$% of the total outstanding commitments in LMA recommended form loan agreements where the sub-participant is able to exercise voting control in respect of "Majority Lender" matters.
[155] Clause 26.1 and 26.2 of the LMA Multicurrency and Revolving Facilities Agreement.
[156] 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.
[157] 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.
[158] And is continuing at the time the elevation is triggered by either the lender of record or the sub-participant.

control rights over the loan[159]. Interestingly both the Bilateral and Multilateral form of termination and transfer agreement produced by the LMA provide for the transfer of the participated commitment to be made only by way of novation which will, therefore, transfer not only the rights of the lender, but also any outstanding obligations, for example, the obligation to make further advances or to convert the relevant facilities into different currencies. Following completion of the procedure for transfer, the original lender is released from its obligations and the sub-participant becomes a party to that agreement as a 'lender' (of record) and thereby enjoys full privity of contract with the borrower including the ability to exercise all rights, powers, and discretions and assume all obligations as if it had been an original lender under the loan agreement.

Do the changes made to the form of sub-participation alter its legal characterisation?

The current form of sub-participation used in the market, although based on the approach originally developed, is significantly more complex and no longer intended to operate purely as a derivative contract that transfers only an economic interest in the underlying loan. If the sub-participation includes the granting of voting rights and elevation[160] the sub-participant will effectively control the exercise of all rights and discretions, and the discharge of the various obligations, of the lender[161] immediately upon the sub-participation being executed, including those relating to its obligation to make further advances,[162]convert to different currencies, and its decision to increase the facilities or make available ancillary facilities[163]. Immediately upon those rights including the ability of the lender to exercise the various 'self-help' enforcement remedies following the occurrence of an event of default (the triggering of which the sub-participant may have influenced or controlled by instructing the lender to 'direct' the Agent in accordance with the 'acceleration' clause in the loan agreement), the sub-participant has an

[159] See section IV (iii), 'Voting and control rights over the underlying loan'.
[160] Interestingly neither of these provisions are included in the standard form sub-participation agreement recommended by the Bankers Association for Finance and Trade (see *www.baft.org*), which was the subject of the recent judgement of S.Houseman KC (sitting as a judge in the High Court) in *Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Ltd* [2023] EWHC 1212 (Comm), see n.105.
[161] Assuming the sub-participation relates to the entire commitment of the lender in the underlying loan. If it relates to only a part of that commitment the voting rights given will reflect the proportional interest of the lender and sub-participant, see n.130.
[162] That control could potentially extend to the initial drawdown by the borrower since the sub-participant would control voting on any decision to withdraw the Agent's authority to confirm satisfaction of the initial conditions precedent, see n.17 and section I (i) 'The Obligation to Lend'.
[163] Assuming the sub-participation includes future funding obligations, which is often the case, see section IV (i).

immediate and unfettered right to trigger the elevation mechanism[164] and require the transfer to it of legal or equitable ownership of those enforcement remedies. This right, to require a legal or equitable transfer of the underlying loan, fundamentally changes the legal nature of the sub-participation agreement, which is no longer intended always to operate as a purely derivative instrument which transfers only an economic or synthetic interest in the loan, indeed, it is contemplated, from the moment the sub-participation is executed, the sub-participant may ultimately hold an ownership interest in the loan and enjoy full privity of contract with the borrower[165]. As originally conceived sub-participation was never intended to transfer any ownership rights in the loan to the sub-participant, it was intended to transfer only an economic interest. The wording of the agreement typically stated that explicitly[166] and the importance of that wording was highlighted by the Privy Council in the leading English law case characterising sub-participation[167].

The combination of the sub-participant's control over voting rights and its right to 'elevate' its economic interest into a legal or equitable interest mean that, immediately upon the execution of the sub-participation agreement, the sub-participant effectively controls the exercise of all rights, powers and discretions of the lender, including those relating to the discharge of its obligations (via its immediate control of all voting rights), and all enforcement rights, whenever those rights, powers and discretions are capable of being exercised. This is because the latter will only be capable of being exercised following an event of default at which time the sub-participant will have an unfettered right to 'elevate' its economic interest into a legal or equitable interest. Formal privity of contract between the lender and the borrower may continue to exist, at least until the sub-participant elevates its position, but it is commercially hollow at all times and has no legal substance when it matters most, i.e. when the lender is able to exercise

[164] This is because all borrower consent requirements in respect of transfer restrictions will cease to apply, see section II.

[165] The LMA appears to recognise 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 [sub-]participation is designed to transfer an ownership interest in the [underlying] loan to the [sub-]participant after the effectiveness of the [sub-] participation", see 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.

[166] See section III.

[167] 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" *Lloyds TSB Bank Plc v Clarke*, n.100 at [997].

enforcement rights against the borrower. At that time, unbeknown to the borrower, there are no restrictions to formal privity of contract being established between the sub-participant and the borrower. Entering into such a sub-participation undermines many of the fundamental terms the borrower has bargained for and, arguably, violates its freedom of contract. The closest analogy to this arrangement is the much criticised[168] doctrine of the undisclosed principal[169] which allows an undisclosed party (the 'undisclosed principal') to enforce a contract entered into by and in the name of another party (the 'agent'), who concealed from the third party that she was acting in such capacity. By this doctrine, either the agent or the undisclosed principal (once disclosed to the third party) may enforce the contract or be subject to enforcement by the third party. Various attempts[170] have been made to reconcile this doctrine with the doctrine of privity but none has garnered much support and the better view seems to be that the undisclosed principal enjoys an independent right[171] to enforce against the third party[172], as another exception to the doctrine of privity, in the interests of commercial utility and convenience[173]. However, the undisclosed principal doctrine is subject to some important limitations and safeguards which seek to prevent injustice[174] to the third party who was unaware of the principal's involvement and thought she was dealing only with the agent. First, as we saw earlier[175], the authority of the agent to act for the principal must have existed at the time the agent contracted with the third party[176]. Secondly, and most importantly for the purpose of our analysis by analogy, the intervention of the principal must be consistent with the terms of the contract and not cause injustice to the third party[177]. Most of the cases dealing with this exception focus on the way the agent describes herself,[178] and whether that precludes the intervention of the principal[179] or where there are circumstances that should lead the agent to

[168] Tan Cheng-Han, *Implied Terms in Undisclosed Agency*, n.134 at 532 and E. Peel, *Trietels Law of Contract*, n.1 at 16-065.
[169] See P. Watts, *Bowstead and Reynolds on Agency*, (Sweet & Maxwell 22nd Ed. 2022) ch.8 and E. Peel, *Trietels Law of Contract*, n.1 at 16-065-16-075.
[170] See *Keighley Maxsted & Co v Durant* [1901] A.C. 240, 261-262.
[171] This is in addition to the independent rights of the agent which are subordinate to those of the principal, *Pople v Evans* [1969] 2 Ch 255 [1968] 2 All ER 743;
[172] *Pople v Evans* n.171; *The Harprins* [1983] 2 Lloyd's Rep. 346.362.
[173] *Siu Yun Kwan v Eastern Ins Co Ltd* [1994] 2 A.C. 199 [207]; Tan Cheng-Han n.134 [533]; E. Peel, *Treitel's Law of Contract* n.1 [16-065] and P. Watts, *Bowstead and Reynolds on Agency*, n.169.
[174] *Keighley Maxsted & Co v Durant*, n.170.
[175] See section IV (iii).
[176] This will rarely be the case in a sub-participation, see section IV (iii).
[177] *Aspen Underwriting Ltd v Credit Europe Bank NV* [2018] EWCA Civ 2590; *Tehran-Europe v Belton* [1968] 2 Q.B. 545.
[178] See *O/Y Wassa SS Co Ltd and NV SS Hannah v Newspaper Pulp and Wood Export Ltd* (1949) 82 Lloyd's Rep 936 and *Finzel, Berry & Co v Eastcheap Dried Fruit Co* [1962] 2 Lloyd's Rep 370, at 375; aff'd [1962] 2 Lloyd's Rep 11, CA.
[179] *Humble v Hunter* (1848) 2 QB 310 at 317; *Formby Bros of Formby* (1910) 102 LT 116.

realise the third party was not willing to contract with the principal[180]. A number of commentators suggest the identity of the principal is irrelevant[181], and while that may be correct in many of the examples given, it is submitted an undisclosed principal should not be permitted to intervene in a contract if she is aware the third party has restricted her right to do so[182], which is the case in LMA style loan agreements, and often the reason why the lender transfers the interest in the underlying loan by way of sub-participation[183].

Unlike the situation in a sub-participation privity between an undisclosed principal and the third party is created immediately upon the agent contracting with the third party and, therefore, the principal is at all times liable to the third party, whether disclosed or undisclosed.

And finally, unlike the situation in a sub-participation, the rights of the undisclosed principal against the third party are subject to any defences, or equities, which the third party can assert against the agent[184], including rights of set-off even if it arose after the contract was entered into provided it did so before the third party became aware of the principal's existence[185]. This rule again seeks to ensure the third party is not prejudiced by being unaware she is contracting with an undisclosed agent.

Conclusion

This article has raised some important questions about the nature of privity of contract in complex term loan agreements, particularly from the perspective of the borrower. It also raises important questions about the legal nature of sub-participation agreements, which can no longer be classified as purely derivative contracts that transfer only an economic interest in the underlying loan[186], and the potential risks to which they give rise for borrowers. Those risks

[180] *Said v Butt* [1920] 3 K.B. 497; *Greer v Downs Supply Co* [1927] 2 KB 28; and *Nash v Dix* (1898) 78 L.T. 445.
[181] Tan Cheng-Han, *Implied Terms in Undisclosed Agency*, n.134 who cites *Said v Butt* n.180 in support of the law not being concerned with the principal's identity (at p. 541). See also *Nash v Dix* n.180 and *Dyster v Randall & Sons* [1926] Ch. 932.
[182] This view is also expressed in *Treitel's Law of Contract*, n.1 at p. [871].
[183] See section II.
[184] *Browning v Provincial Ins. Co. of Canada* (1873) L.R. 5 P.C. 263 at 272.
[185] The third party can also rely on any misrepresentation made by the agent in respect of the contract, *Gilbert Browning v Provincial Insurance Co of Canada* (1873) LR5 PC 263 at 272.
[186] Similar concerns arise in respect of other more conventional forms of derivative or synthetic risk transfers, for example, total return swaps and credit default swaps which increasingly transfer voting rights and require

potentially adversely impact the terms bargained for by the borrower in a term loan contract (and how the rights, obligations and discretions applicable to those terms will be exercised[187]); undermine privity of contract with its lenders; violate its freedom of contract; and cause it material injustice. English law provides no defences to a borrower against such injustices, as it does, for example, under the doctrine of undisclosed principal. Indeed, one might argue the injustices are potentially far greater in the case of sub-participation and they are difficult to justify on the basis of 'commercial utility and business convenience'[188]. The only way in which a borrower can currently seek to protect itself against such injustices is to extend transfer restrictions in the underlying loan to include all derivative, economic, and synthetic risk transfers, especially those which include the transfer of voting rights and a contingent future legal or beneficial interest in the loan. However, there are doubts about the effectiveness of such restrictions since they are unlikely to invalidate the derivative transfer of an economic interest in the loan as between the lender and the sub-participant. They would give rise to a breach of contract by the lender, and potentially enable the borrower to seek an injunction preventing the lender from proceeding with the sub-participation, provided the borrower has notice of the threatened breach,[189] and, potentially, a claim against the sub-participant for the tort of inducing breach of contract provided the conditions stated by Lord Hoffman in *OBG Ltd v Allen; Douglas v Hello! Ltd; Mainstream Properties Ltd v Young*[190] are satisfied. However, neither of those remedies would be optimal for the borrower and would present additional challenges for both lenders and borrowers from a commercial perspective in the current market[191]. That is because they would inevitably result in a material reduction in the availability and liquidity of term debt finance (and possibly an increase in pricing) at a time when both are considered crucial[192] to facilitate the required level of lending to the real economy.

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physical delivery of the underlying loan asset to the credit protection seller following an event of default, see n.118.

[187] In the context a 'dynamic' and 'incomplete' loan contract which the parties implicitly recognise will need to be renegotiated numerous times during its term, see section I.

[188] which is how some have sought to justify the doctrine of undisclosed principal, *Keighley, Maxsted & Co v Durant* n.170, see also *Bowstead and Reynolds on Agency* n.169, M. Furmston, Cheshire Fifoot & Furmston's *Law of Contract* (17th ed. 2017 OUP); and J.B. Aines, *Undisclosed Principal – his rights and liabilities* (1909) 18 Yale L.J. 448.

[189] *Doherty v Allman* (1878) 3 App Cas 709.

[190] [2007] UKHL 21.

[191] See G. Penn, *Promoting Liquidity in the Secondary Loan Market: Is Sub-Participation Still Fit for Purpose?* n.80; and F. Khan, T. Gausel, T. Mann and D. Neale, *Transfer Restrictions in Leveraged Lending Transactions: time for a re-assessment,* (2022) 4 JIBFL 251.

[192] A number of regulators and industry bodies have recently stressed the importance of freeing up the balance sheets of regulated banks, via the secondary markets, to increase their ability to provide debt finance to the real economy, see Directive (EU) 2021/2167 on credit servicers and credit purchasers and the European Banking

Authority report on transferring non-performing loans (EBA/ITS/2022/05 (16 December 2022)); and The Bank of England Financial Stability Report (December 2022).