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SEPTEMBER 2026

EDITOR'S NOTE: DECISIONS, DECISIONS

Victoria Prussen Spears

TWO RECENT DECISIONS ADDRESS THE PLEADING STANDARD FOR PREFERENCE ACTIONS

Jason W. Harbour and Olivia "Liv" Maier

WASHINGTON SUPREME COURT LIMITS REMEDY OF NONJUDICIAL FORECLOSURE TO HOLDERS OF NEGOTIABLE INSTRUMENTS

Rhys W. Hefta, Kari L. Larson and Christian Scarlett

CRITERIA TO CONSIDER WHEN ASSESSING BORROWING BASE CREDIT FOR PARTICIPATION INTERESTS

Jakarri Hamlin and Linda E. Boss

EU INSOLVENCY DIRECTIVE II: ANOTHER STEP FORWARD IN THE HARMONIZATION OF EUROPEAN INSOLVENCY LAW

Giuseppe Scassellati-Sforzolini, Francesco Iodice, Sara Maria Crupi, Roberto Bonsignore, Kasper Theunissen, Mirko von Bieberstein and Aude Dupuis

ALGORITHMIC GOVERNANCE IN THE VICINITY OF INSOLVENCY: RETHINKING DIRECTORS' FIDUCIARY DUTIES IN THE AGE OF ARTIFICIAL INTELLIGENCE

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VOLUME 22

NUMBER 6

September 2026

Editor's Note: Decisions, Decisions

Victoria Prussen Spears

237

Two Recent Decisions Address the Pleading Standard for Preference Actions

Jason W. Harbour and Olivia "Liv" Maier

239

Washington Supreme Court Limits Remedy of Nonjudicial Foreclosure to Holders of Negotiable Instruments

Rhys W. Hefta, Kari L. Larson and Christian Scarlett

243

Criteria to Consider When Assessing Borrowing Base Credit for Participation Interests

Jakarri Hamlin and Linda E. Boss

249

EU Insolvency Directive II: Another Step Forward in the Harmonization of European Insolvency Law

Giuseppe Scassellati-Sforzolini, Francesco Iodice, Sara Maria Crupi,
Roberto Bonsignore, Kasper Theunissen, Mirko von Bieberstein and Aude Dupuis

253

Algorithmic Governance in the Vicinity of Insolvency: Rethinking Directors' Fiduciary Duties in the Age of Artificial Intelligence

Bamdad Shams

262

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT’S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the “Rescue and Recovery” Culture for Business Recovery*, 10 PRATT’S JOURNAL OF BANKRUPTCY LAW 349 (2026)

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Criteria to Consider When Assessing Borrowing Base Credit for Participation Interests

*By Jakarri Hamlin and Linda E. Boss**

In this article, the authors explore the considerations that a warehouse lender should bear in mind when deciding whether to provide borrowing base credit for participation interests and defining eligible participation interests.

A participation interest is a contractual right held by the participant to receive a portion of the loan receivables payable by the underlying obligor that are allocable to the participant's interest. The participant is not the lender of record and usually has no contractual privity with the underlying obligor. Rather, the underlying obligor maintains its direct relationship with the lender of record, and the participant's interest may be undisclosed.

From a warehouse lender's perspective, participations can introduce legal uncertainty and practical constraints when the lender is relying on such assets for credit support. In particular, taking a first-priority, properly perfected security interest in an asset that is both transferable and directly collectible is more complicated when the asset is a participation interest. Although specifics vary, issues relating to:

- (a) the legal characterization of the participation and insolvency risk of the lender of record;
- (b) transferability, control and enforcement; and
- (c) liquidity and valuation generally weigh against giving full borrowing base credit to participations (subject to potential mitigants, as discussed below).

LEGAL CHARACTERIZATION AND INSOLVENCY RISK

Participations are designed to be a true sale of an undivided, *pro rata* interest in the economic rights of an underlying loan, with the underlying obligor's credit risk passing to the participant on a non-recourse, pass-through basis. As such, the participant is generally expected to be a secured creditor of the underlying obligor, consistent with the lender of record's position. However, if a purported participation is recharacterized as a secured loan to the lender of record, the participant may become a general creditor of that lender, losing the

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intended priority in proceeds of the underlying loan. That recharacterization risk is significant for warehouse lenders; in a facility secured by participations, the warehouse lender must consider the creditworthiness of both the lender of record and the underlying obligor.

Additionally, collections corresponding to a participation may be commingled with the lender of record's funds before remittance to the participant. If the lender of record becomes insolvent, commingling and servicing dependencies can convert what should be asset cash flows into bankruptcy claims. If participations are permitted as eligible collateral, warehouse lenders should confirm that they include clear characteristics of a true sale and express segregation, trust, or custodial provisions for collections, together with waivers of setoff and acknowledgments designed to minimize commingling and bankruptcy risks.

TRANSFERABILITY, CONTROL AND ENFORCEMENT

Enforcement is more straightforward for direct loans than for participations. Following foreclosure on a direct loan, a warehouse lender can become the lender of record or sell that status to a third party, resulting in ownership of the full bundle of lender rights, including consent rights over amendments, waivers and enforcement. By contrast, foreclosure on a participation typically results in ownership of the participant's contractual rights under the participation agreement, not privity with the underlying obligor. The warehouse lender must rely on the lender of record to exercise remedies, manage amendments and conduct workouts, unless the participation provides a prearranged elevation mechanism or robust step-in rights that allow conversion to a direct assignment upon specified triggers. Even if such elevation rights are prearranged, in the event of the lender of record's insolvency, any such rights would be subject to the automatic stay of a relevant bankruptcy court, and a motion for relief would be necessary to remove the stay and collect on the asset. Because the warehouse lender is a creditor of the participant, it may have limited influence over the participant's arrangements with the lender of record and may be subject to the existing mechanics.

Voting rights are critical in distress, but participations commonly allow the lender of record to maintain control over any next steps. In syndicated contexts, participants are not always treated as lenders for voting purposes, and their voting rights are often limited to apply only when the participant is directly affected. Accordingly, it would not be uncommon for a participant to lack consent rights over certain types of amendments or other decisions that may materially affect the asset's value.

Transferability constraints can further differentiate participations from direct loans. Contractual restrictions, such as underlying obligor consent and eligible

transferee provisions, can delay or block assignments. While participations may be easier to enter into at origination, they are often harder to assign in distressed scenarios if transfer rights are constrained and elevation is not adequately addressed. Confidentiality obligations and obligor consent requirements can also impede a participant's ability to engage directly with the underlying obligor or transfer the participant's interest, particularly in a situation where the underlying obligor or the lender of record is in distress.

LIQUIDITY, VALUATION, AND BORROWING BASE IMPLICATIONS

Liquidity for participations is generally narrower than for direct loan interests, and buyers may discount for reduced control, limited transparency and servicing considerations. These dynamics affect valuation and ultimately, the applicable haircuts. Participations can also complicate concentration limits because exposures exist to both the lender of record and the underlying obligor. Even if structured as a true sale, cash flows depend on proper servicing, segregation of funds and timely remittance by the lender of record, and bankruptcy risks to the lender of record remain intact. These factors often justify tighter eligibility tests, lower advance rates, and shorter recognition periods for participation interests.

WHAT ARE THE PRIMARY CONSIDERATIONS WHEN DEFINING AND LENDING AGAINST ELIGIBLE PARTICIPATION INTERESTS?

In a warehouse facility's loan documents, an "Eligible Participation Interest" is typically a participation interest that qualifies for borrowing base credit and is permitted as eligible collateral under the facility. In practice, warehouse lenders define the term Eligible Participation Interest narrowly, adjusting valuation and concentration metrics to reflect the risks described above.

A common approach is to permit participations in the borrowing base only for a limited period (e.g., 30–60 days) following the latter of the borrower's acquisition of the asset or the closing of the facility, after which the participation must be elevated to a full assignment to the borrower. This approach provides the borrower with temporary flexibility to obtain credit while satisfying conditions to elevate the interest and become the lender of record, and it limits the warehouse lender's exposure to the participation to a short, transitional window.

Another frequent limitation is to allow borrowing base credit only when the lender of record is the participant's parent or sister company. This approach increases the likelihood that the warehouse lender can review participation documentation and confirm clear servicing standards, including duties to consult and, where appropriate, to follow participant instructions, together

with remedies if the lender of record fails to perform, such as replacement or step-in rights. When combined with a strict elevation timeline, this approach narrows the warehouse lender's participation-related exposure to the period required to facilitate the borrower's acquisition and elevation of the asset rather than to the life of the facility.

In addition, or as an alternative, warehouse lenders may accept participations as eligible collateral while mitigating risks through tailored criteria. For example, eligibility standards may:

- (a) require that all Eligible Participation Interests be freely transferable to the warehouse lender or its designee without additional consents or restrictions;
- (b) require appropriate voting and consent rights to be held by the participant;
- (c) mandate step-in or buy-out rights for the benefit of the participant if the lender of record fails to act; and
- (d) require pre-arranged elevation mechanics to be in place, with executed, escrowed transfer documents and obligor consents.

Facilities may also impose tighter concentration caps, more stringent eligibility tests, and more conservative haircuts. Where participations receive borrowing base credit, lenders should diligence the underlying assets and calibrate criteria to the specific risk profile.

CONCLUSION

Participation interests, while commercially useful for originators, can make it more difficult for an asset-backed lender to address risks related to the enforceability, transferability, control, and liquidity of an asset. Warehouse lenders should therefore analyze whether an asset is a participation and, if so, whether it should qualify as an Eligible Participation Interest. When setting the parameters for Eligible Participation Interests, lenders may impose limited durations prior to elevation or other mitigants, such as elevation rights, and, in general, should endeavor to make the participation approximate, as closely as practicable, the rights and remedies available in the case of a direct loan. To protect underwriting and recovery, asset-backed facilities should include specific protections if participation interests are given borrowing base credit.