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Participations in the Fund Finance Market

By Kiel A. Bowen and Andi M. Wilt*

In this article, the authors explain that participations are increasingly being used in the finance industry, serving as a mechanism for lenders to manage credit exposure, diversify loan portfolios, optimize capital utilization, and distribute risk among multiple parties. The authors clarify the distinctions between participations and assignments, outline the general scope and structuring options for participation agreements, and detail considerations for lenders evaluating these arrangements, including potential balance sheet benefits.

A participation is when a lender in a credit facility (the Lender of Record) sells a portion of its loan exposure to one or more third-party financial institutions (each, a Participant). A Lender of Record may sell a participation interest in amounts already advanced and/or in commitments to make loans in the future. Participations can take many forms depending on the negotiations between the Lender of Record and the Participant, with the agreed terms documented in a participation agreement.

PARTICIPATIONS VERSUS ASSIGNMENTS

In an assignment, the existing lender – the assignor – transfers its rights, interests, and obligations in the assigned loan (which may be all or a portion of the assignor's total loan commitment) to the assignee. Assignments include a transfer of the right to receive payments from the borrower, the right to enforce the terms of the credit agreement, and, in the case of an assignment of obligations, the obligation to perform the lender's duties relating to the loan.

Furthermore, credit agreements often prohibit an assignment of rights without the corresponding assignment of obligations, requiring the transfer of the entire ownership interest in the loan. After an assignment, the assignee has a direct relationship with the borrower. The borrower is aware of, and may be required to consent to, the assignment, payments are made directly to the assignee, and the assignee interfaces directly with the borrower. In other words, on a go-forward basis, the assignee steps into the assignor's shoes and becomes a creditor of the borrower.

On the other hand, in a participation, the Participant acquires an interest in the loan, but the Lender of Record retains title to the loan and maintains a direct relationship with the borrower. Unlike an assignment where the assignee is the acknowledged replacement of the assignor, the Participant has an indirect

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and often undisclosed relationship with the borrower. The Lender of Record continues to receive payments from the borrower and then passes the payments on to the Participant according to the terms of the participation agreement. The Participant is not a creditor of the borrower, and, as discussed below, has a different set of rights and obligations compared to the Lender of Record.

Participations are more flexible than assignments because they can be structured to accommodate the specific needs and preferences of a Lender of Record and Participant through the participation agreement, whereas assignments typically involve a complete transfer of the loan interest, often pursuant to a prescribed form attached as an exhibit to the credit agreement.

The flexible nature of participations can additionally be helpful in the context of portfolio sales, where certain requirements for transfer, such as the giving of notices or receipt of consents, must be satisfied prior to completion of the transaction. In such situations, parties may enter into a participation agreement with an elevation clause, which facilitates the transfer of the economic interests in loans while the Lender of Record retains the title to the loans until the conditions precedent to transfer are satisfied. Upon satisfaction of the conditions precedent, the participation can then be elevated to a full assignment of rights, transferring the title to the loan and completing the sale or transfer of the loans.

Lenders of Record seeking to optimize their balance sheets are increasingly utilizing participations as a strategic tool, as transferring the economic interests in a loan without transferring title can offer capital benefits. However, participations structured for this purpose require careful attention to banking regulations and accounting standards.

TYPICAL TERMS OF PARTICIPATION AGREEMENTS

A participation agreement governs the terms for a Participant's purchase of the participation interest in the Lender of Record's loans and/or commitments under a credit facility. A participation interest can be sold in loans already advanced and/or in the Lender of Record's commitment to make loans in the future under the terms of the credit agreement. When a Lender of Record and a Participant are using an LSTA-based form, parties may rely to an extent upon standard market language, with the most significant negotiation typically focused on provisions impacting payment obligations and Participant control.

- *Payments*: The participation agreement will include provisions governing how the borrower's payments to the Lender of Record will be transferred to the Participant, including any fees owed to the Lender of Record under the credit facility, as well as the responsibility of the Lender of Record and Participant to share any expenses and fees relating to the administration of the participation agreement. If the Participant has purchased an interest in ongoing unfunded commitments, the participation agreement will also set forth when and how the Participant will pay the Lender of Record when the purchased commitments are to be funded. This includes details like required notice and funding timelines. Particular focus is needed for payment obligations in revolving credit facilities, addressing aspects such as potential funding thresholds for the Lender of Record to satisfy before the Participant must fund, or maximum funding amounts for the Participant.

- *Voting Rights*: The Participant will not typically have voting rights, except in limited situations where the Participant would be directly affected by an amendment or modification to the credit facility. Voting rights provisions will stipulate the specific situations in which the Participant will have voting rights, such as sacred right amendments that would reduce or postpone a scheduled payment under the credit facility, a release of a material portion of the collateral, or other changes that would directly impact the Participant, and decisions to exercise (or refrain from exercising) other rights or remedies.
- *Transfers*: These terms provide to whom, if anyone, the Participant and Lender of Record may assign their respective obligations under a participation agreement and any conditions precedent to transfer, such as notice or consent requirements, satisfaction of regulatory requirements, or ensuring the transferee meets credit or operational standards agreed upon by the parties.
- *Information Rights*: These provisions stipulate how the Lender of Record and Participant will share information, such as the provision of copies of all credit documents and amendments, copies of all documents delivered to the Lender of Record regarding the credit facility, and information regarding performance under the credit facility (such as notice of default).
- *Liability and Indemnification*: The Lender of Record may disclaim any liability regarding legality, validity, and enforceability of the credit facility. The Lender of Record may also be further protected from liability through provisions stating the Lender of Record will be indemnified by the Participant for costs and expenses related to its acting or refraining to act pursuant to any direction of the Participant and otherwise relating to the administration or maintenance of the loan. While beyond the scope of the participation agreement, note that the Participant may be able to benefit from certain indemnification

provisions in the credit facility, such as indemnification from a borrower for certain taxes, and the Participant may in some cases have the right to rely on legal opinions delivered to the Lender of Record.

- *Representations and Warranties*: While the specific language agreed to in the participation agreement may vary, the Lender of Record will often represent it is the sole owner and has good title to the loan exposure that the Participant is purchasing, has authority to sell the interest, that executing and performing the participation agreement will not contravene documents that the Lender of Record is bound by (such as the credit facility); and that either no consents are necessary or all required consents have been obtained. The Participant may represent to its valid execution of the participation agreement and acknowledge that it is entering into the agreement based on its own evaluation of the borrower's creditworthiness.
- *Other Terms Required by the Credit Agreement*: In some cases, the applicable credit agreement will include some specific requirements and prohibitions regarding the rights of Participants. For example, a credit agreement may require that a participation agreement stipulate that the Lender of Record retain the sole right to enforce the credit agreement and approve any amendment, modification, or waiver to the credit agreement (subject to certain amendments, waivers, or modifications that may directly affect the Participant); accordingly, the participation agreement may include additional provisions as required by the applicable credit agreement.

OTHER STRUCTURES FOR PARTICIPATION AGREEMENTS

In addition to the participation agreement governing a Participant's interest in a single loan, participation agreements may also be structured for large-scale participations across multiple credit facilities through master participation agreements.

Master Participation Agreement (MPA)

An MPA allows a Lender of Record to sell participation interests in multiple loans under a single framework. MPAs create efficiencies, in particular for lenders managing large loan portfolios with recurring counterparties, by limiting negotiation of the core terms to the outset of the transaction. Once in place, additional participation interests may be added under the MPA through simple supplements or addendums to the MPA. As with a participation agreement governing a single participation interest, there are standard form agreements for MPAs, including an LSTA form, which simplifies negotiations.

Parties negotiating an MPA also need to consider which future participation interests could be governed by the MPA. This includes defining the eligibility criteria for the loans, such as borrower creditworthiness, loan-to-value thresholds, and borrower/sponsor, sector, and geographic concentration limits. Under an MPA, eligibility criteria may be specifically tailored to the underlying loans as well as the portfolio as a whole. A Participant may be able to obtain review and approval rights for each loan under the MPA and may have the ability to reassess whether underlying loans maintain eligibility, especially if there are amendments or waivers to underlying credit facilities. Under a participation agreement governing a single participation interest, the Lender of Record may be held to a standard of care of acting in good faith and exercising reasonable judgment; under an MPA, the Lender of Record may be held to a higher standard of care or the standard of care may be more explicitly described under an MPA as it is intended to govern multiple participations over time.

Blind Pool

MPAs may also be structured through a blind pool where a Participant participates without knowing the specific underlying loans in which it is buying participation interests. Negotiation for blind pool participations necessarily differs from that in other types of participations, as the diligence regarding specific assets and underlying loan documents is predicated on reliance on the Lender of Record, which acts as a servicer managing the portfolio pursuant to negotiated servicing standards and broadly defined eligibility criteria and concentration limits.

Parties to a blind pool agreement negotiate the eligibility criteria that loans must satisfy to be included in the blind pool; however, the eligibility criteria under a blind pool are often broader and applied at the portfolio level as well as on a loan-by-loan basis. The eligibility criteria for blind pools may include borrower/sponsor, sector, and geographic concentration limits and target return thresholds. As a Participant in a blind pool is unable to evaluate the underlying loans, it is reliant upon the Lender of Record as the servicer. The Lender of Record may be required to agree to maintain a certain percentage ownership of the underlying loan interest and to ensure fair treatment, avoid conflicts of interest, and act in the best interests of a Participant.

WHAT A LENDER OF RECORD SHOULD CONSIDER WHEN EVALUATING A PARTICIPATION

Regardless of the type of participation agreement selected by the parties, there are certain considerations to be made by a Lender of Record.

- *Contractual Rights*: The Lender of Record should ensure the participation agreement clearly defines the rights and obligations of the Lender of Record and the Participant, including standard of care, payment terms, voting rights, and dispute resolution.

- *Consents*: In the negotiation of a credit facility, a borrower might negotiate for the right to be notified of, or grant consent for, any participation. At the time a participation is being considered, the Lender of Record should determine whether the borrower's consent to the participation is required, and if so, coordinate with the borrower.
- *Confidentiality*: When sharing credit documents with the prospective Participant as it conducts its diligence, the Lender of Record must maintain any confidential information pursuant to the terms of the credit agreement. Borrowers might also attempt to exert indirect control over the participation process by negotiating restrictions on the disclosure of confidential information to Participants.
- *Regulatory Capital Treatment*: If the Lender of Record is a bank, it must maintain a minimum amount of capital relative to its credit risk. For the drawn portion of a credit facility, the Lender of Record would need to hold capital against the entire facility unless (i) the participation qualifies for de-recognition under Generally Accepted Accounting Principles (i.e., as a true sale under ASC 860) and (ii) the interests of the Lender of Record and Participants are pari passu. This may require the Lender of Record to agree to more generous transfer restrictions and limit the protective provisions the Participant has against the Lender of Record. For the undrawn portion of a credit facility, the Lender of Record and Participant also must agree that their funding commitments will be drawn on a pro rata basis for the Lender of Record to obtain favorable capital treatment.
- *Regulatory Compliance*: The Lender of Record must ensure that a participation agreement complies with applicable banking regulations and accounting standards, including any jurisdiction-specific capital treatment rules, disclosure obligations, compliance with anti-money laundering (AML) and know-your-customer (KYC) requirements.
- *Balance Sheet Optimization*: Lenders of Record have been increasingly utilizing participations as a tool for balance sheet optimization to achieve capital relief, risk mitigation, improved liquidity and management of concentration risk and supervisory limitations.
    - *Capital Relief*: By selling participations, the Lender of Record may be able to reduce the outstanding loan balances reflected on their balance sheets. Reducing these balances can improve regulatory capital ratios under regulatory frameworks, allowing the Lender of Record to free up capacity for new lending.
    - *Risk Mitigation*: The Lender of Record may utilize participations

to share credit exposure with Participants, which may lower the Lender of Record's concentration risk. A participation also distributes loan exposure across multiple financial institutions, mitigating counterparty risk.

- *Liquidity Management and Relationship Maintenance*: The Lender of Record may use participations to reduce their credit exposure without relinquishing client relationships, often achieved by retaining servicing responsibilities. By reducing their credit exposure, the Lender of Record can free up liquidity for new opportunities or operational needs.

CONCLUSION

Participations are an effective way for lenders to manage their credit exposure, diversify loan portfolios, optimize capital utilization, and distribute risk. When negotiating and executing a participation agreement, a Lender of Record should ensure that it adequately addresses diligence, key provisions, rights and obligations, confidentiality, and risk mitigation to effectively utilize this valuable tool. Participations may be governed by different types of agreements with varying levels of control with respect to the underlying participation interests, providing flexibility for Lenders of Record and Participants to structure the agreement to fit their needs.