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ARTICLE

Lehman Strikes Again: European Loan Participations and Preference Risks

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In the growing global market for commercial loans, market participants buy and sell syndicated loans using increasingly streamlined and standardised transfer structures. While loans are often sold directly by 'assignment,' it is also common practice to buy and sell loans by 'participation'. Under the participation structure, the seller (commonly referred to as the grantor of the participation) continues to be the lender to the borrower, but enters into a separate back-to-back arrangement with the buyer of the loan and 'grants' to the buyer (commonly referred to as the participant) a 'participation interest' in the loan, thereby transferring the economic risk of the loan to the buyer. As far as the borrower is concerned, nothing has changed, but where the seller and buyer are concerned, risk has been transferred. The specifics of the contractual relationship may vary from market to market but the methodology remains the same, along with the risk that all payments flow through the grantor.

Over time and as circumstances change, loans that were beneficially owned by way of participation can (in the jargon of the secondary bank loan market) be 'elevated' to direct assignments once the requisite administrative agent and/or borrower consent is obtained. This will often happen upon a sale of the loan by the participant to a third party, or where the underlying commercial reason for holding the loan by way of participation no longer prevails. Such 'elevations' customarily have been viewed as straightforward transactions -- when completed, the participant simply stands in the shoes of the grantor and becomes the lender of record of the loan on the books of the administrative agent.

Recent events in the Lehman bankruptcy proceedings, however, have raised questions about the effectiveness of elevations involving the standard form of participation agreement used in Europe and has resulted in monetary claims being brought by the Lehman estate against parties that elevated the pre-petition participations granted by Lehman, and, in some cases, may result in the painstaking unwinding of chains of sales and purchases of bank loans that were once owned by Lehman.

Background

Prior to their bankruptcy filings, Lehman Commercial Paper Inc. ('LCPI'), a subsidiary of Lehman Brothers Holdings Inc., and other Lehman subsidiaries originated commercial loans to borrowers and sold participation interests in such loans to third parties in the ordinary course of their business.

Certain parties requested elevations of their status from participants to lenders, and asked LCPI to assign or novate to them the underlying ownership interests in the loans, thereby removing LCPI from the chain of payments. At the time, LCPI agreed to these elevation requests and the elevations became effective either prior to LCPI's bankruptcy filing or shortly thereafter. In fact, on 6 October 2008, the day after its bankruptcy filing, the United States Bankruptcy Court entered an order in the LCPI bankruptcy proceeding (the '*Elevation Order*') that authorised LCPI, in consultation with the Official Committee of Unsecured Creditors in the Lehman bankruptcy cases, to elevate loan participations in accordance with the applicable credit agreements.[1] The Elevation Order also provided, however, that 'notwithstanding such elevation of participations ... neither the Debtor nor the Committee nor any party in interest shall, by virtue of this Order, waive the right to subsequently argue that such participations ... are not true participations and that any cash or securities distributed to holders of such participations ... was property of the estate'.[2]

Notes

1 *Order Pursuant to Sections 105(a), 363(b), and 541(d) of the Bankruptcy Code and Bankruptcy Rule 6004 Authorizing Debtor to (A) Continue to Utilize its Agency Bank Account, (B) Terminate Agency Relationships, and (C) Elevate Loan Participations*, dated 6 October 2008 [Docket No. 11 in the Bankruptcy Docket for Lehman Commercial Paper Inc., Chapter 11 Case No. 08-13900 (JMP)].

2 Elevation Order at p. 4.

LCPI is now seeking to unwind certain elevations of loan participations that occurred shortly after the holding company's bankruptcy filing on 15 September 2008 but prior to its own bankruptcy filing on 5 October 2008. The participations at issue were documented on participation agreements that were substantially similar to those published by the Loan Market Association ('LMA').[3] In essence, even though LCPI previously agreed to certain elevation requests, which became effective in late September and early October 2008, LCPI is now alleging that such elevations constitute preferential transfers that should be avoided under the United States Bankruptcy Code and that payments received by the participants following the elevations should be returned to the Lehman estate.

LMA participations vs. LSTA participations

LCPI alleges that under LMA-style participations, participants have no contractual relationship with the underlying borrower, no ownership interest in the relevant loan and no legal right to pursue the borrower for principal or interest payments. Instead, LCPI asserts that LMA participants only have a debtor/creditor relationship with LCPI, in its capacity as the grantor of the participation.

These allegations regarding LMA participations are in contrast to participations that are documented on form agreements published by the Loan Syndications and Trading Association ('LSTA'). LSTA participations generally provide, among other things, that (i) the participant receives a beneficial interest in the underlying loan, with the grantor retaining only legal title to the underlying loan, (ii) the grantor receives and holds any principal or interest payments from the relevant borrower for the sole benefit of the participant, and (iii) the participation is intended to be treated as a sale by the grantor and as a purchase by the participant.

Preference and recovery of avoided transfers

LCPI asserts that the elevations in question meet the elements of avoidable preferential transfers under the United States Bankruptcy Code. Specifically, LCPI alleges that the elevations: (i) constituted transfers of LCPI's interest in property; (ii) occurred within 90 days of LCPI's bankruptcy filing; (iii) were to or for the benefit of the participants; (iv) were made on account of antecedent debts owed by LCPI to the participants under the LMA participations; (v) were made at a time when LCPI was presumed to have been insolvent;[4] and (vi) resulted in payment in full of the debts and liabilities of LCPI to the participants, who are mere unsecured creditors of LCPI, enabling the participants to receive more than they would have received in a Chapter 7 liquidation.

Further review and analysis of the underlying documents and facts regarding each participation will be necessary to see if there are any defects in or defences to the claims made by LCPI (e.g. was there an antecedent debt, was the transaction in the ordinary course of business, or did the participant provide new value). To the extent the elevations are deemed to be preferences, LCPI also seeks to recover any payments of principal, interest and fees the participants received from the relevant borrowers subsequent to the elevations.

Tolling and stay of proceedings

Under the United States Bankruptcy Code, LCPI had to bring proceedings to unwind elevations of LMA participations within two years of its bankruptcy filing. LCPI did, in fact, bring such avoidance actions against certain parties but also entered into tolling agreements with more than 4,100 parties to preserve rights and to avoid the need to commence litigation. To the extent LCPI is unable to reach consensual resolutions with LMA participants that entered into such tolling agreements, it is likely that LCPI would commence proceedings to unwind the applicable elevations prior to the termination of the agreed upon tolling periods.

Prosecution of the avoidance actions that were brought were also stayed for a period of nine months, subject to certain conditions, pursuant to an order entered by the United States Bankruptcy Court on 20 October 2010 in order to permit the parties to engage in discussions to try to consensually resolve the disputes.[5]

Conclusion

The proceedings brought by LCPI to avoid the elevations of LMA participations and to claw back payments received by the participants implicate not only the individual defendants named in the complaints, but other participants that entered into tolling agreements with LCPI and potentially other parties that may have purchased elevated loans from such parties.

Market participants should therefore closely examine their inventory of loans and confirm whether they

Notes

3 Some of the agreements may contain specific provisions regarding elevations, whereas other agreements may not contain such provisions.

4 Pursuant to section 547(f) of the United States Bankruptcy Code, debtors are presumed to have been insolvent on and during the 90 days immediately preceding the date of commencement of a bankruptcy proceeding.

5 *Order Staying Avoidance Actions and Granting Certain Related Relief Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rule 7004(a)(1)*, dated 20 October 2010 [Docket No. 12199].

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elevated any loans documented on LMA participation agreements during or since the September/October 2008 period that may have had LCPI or other Lehman entities in the upstream chain of title and further satisfy themselves that they have sufficient protection in their sale and purchase agreements that would give them recourse to their sellers if either the elevation is unwound, or if they have to disgorge any payments received from the borrower since that time.

Ultimately, until there is greater legal certainty about the novel issues raised by the LCPI proceedings, market participants should recognise that a 'claw back risk' exists when elevating an LMA participation to a direct assignment when the grantor is potentially insolvent. In practical terms, it clearly is better to be a participant that was successful in elevating its participation interests than not, even if it leads to a potential claw back risks, since litigation is never certain. Two practical lessons can therefore be learnt from this situation, namely, (i) one should regularly monitor the creditworthiness of the grantor, and (ii) when the opportunity to elevate presents itself, do not delay.

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International Corporate Rescue

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