

SELL DOWNS OR PARTICIPATIONS AS  
ALTERNATIVES TO SYNDICATIONS:  
CURRENT TECHNIQUES AND PROBLEMS

Comment by

JEFFREY BROWNE

Sullivan & Cromwell  
Solicitors, Victoria

The current financing techniques and the forms of syndications and participations that George Forster has just described have been, as I think you all probably know, used very extensively in recent times. This has been for various reasons, but principally because some loans, particularly large international loans, are so large that no single financial institution would have the capacity or the wish to lend the entire sum on its own. This desire to spread the risk has been the main reason for the use of these techniques, particularly with some of the large sovereign borrowings in developing countries.

In addition to the desire to spread the risk, these techniques have grown in popularity to enable borrowers also, looked at from their side, to gain access efficiently to very large sums of money, without the necessity of dealing on an individual basis with all of the lenders who would need to be involved to fulfil that large need.

Also, in more recent times, "asset trading" among banks has increased and this also is often done to reduce exposure. It is done through use of these techniques from time to time. In Canada and in the United States we have seen many examples where one bank has been over exposed, in terms of perhaps risk of borrower default, or in terms of risk of future funding requirements in one particular business sector, for example, resource exploration. Also some asset trading has been done by banks, of course, to improve profitability and the balance sheet in the short term.

Looking purely at the legal effect of syndications compared with participations, in my experience banks sometimes, if they can manage it, prefer a direct loan syndication. The principal reason for this is obvious from the different legal effects of a syndication compared with a participation. In brief, it seems clear that the subsequent grant of participations is, from a legal point of view, less satisfactory from both the lead bank's perspective and from the participant's perspective, than signature by all parties of the loan agreement directly. From

the lead bank's perspective, when they subsequently grant participations, they still remain liable generally to the borrower for the full extent of the obligations under the original loan agreement.

The participants, on the other hand, must bring the risk of the lead bank into the credit evaluation as well as the risk and credit evaluation of the borrower.

In addition to these direct legal consequences, however, there are some other benefits of direct loan syndications, or looked at from the other side, perhaps problems that can arise in some participations.

One of them is that a direct loan syndication is less likely to be classified in some jurisdictions as a security for purposes of the securities regulation laws than on indirect participation. For example under US securities laws, the key test on this, summarizing it briefly, is that if the note or the participation represents an investment, it is a security; if it represents a commercial loan, then it is not. One of the tests in determining that is whether or not an investment contract is involved, and that brings into play, whether or not there is an investment of money in a common enterprise with the expectation of profit. A syndication involves lenders acting on a several basis. However, participations, with rights shared on a pro rata basis in payments, arguably involves a common enterprise and there are a few cases that have gone off in that direction.

Another problem that can arise is in a syndicated loan you create a debtor/creditor relationship between the borrower and each of the lenders in the syndicate, and thus a bank lender has a common law, and in some jurisdictions a statutory, right of set-off against the borrower. A participation has been held not to create such a relationship, so that a bank holding a participation may not exercise a right of set-off against the borrower.

Another problem that one should be aware of is that it is not clear whether and to what extent a bank holding a participation will get the benefits of the indemnity or other protection clauses that are in the documentation between the lead bank and the borrower. I refer, for example, to the typical Eurodollar clauses covering additional costs or alternative rates, or illegality, or foreign taxes etc set forth in the credit documentation between the borrower and the lead bank.

Another problem is the double credit risk that I referred to earlier with participations. Depending upon how the participation is characterized under the relevant law, the participating bank may have no legal or equitable interest in the actual funds received by the lead bank. If that is the result in the particular jurisdiction, then if the lead bank becomes bankrupt, the participating bank may only have a pro rata claim along with other creditors in the assets of the bankrupt bank.

Despite some of these problems with participations, syndicating a credit through participations has become very useful in some

situations, and has some very definite practical and legal advantages. One of them is that the lead bank may not wish to compromise its relationship with a borrower by introducing competitors. In a participation, of course, that is got around by the fact that the arrangements with the borrower remain undisturbed and the participating bank does not become involved directly in the commercial relationship between the lead bank and its customer.

Another advantage is that the loans of a particular bank, who may become the lead bank in a syndication, may exceed regulatory or internal ceilings that would be applicable. As you know, in many jurisdictions loans made by a bank to a single borrower are limited.

The procedure can also be used to get around usury or money-lending restrictions which prevent the syndicate making the loan directly themselves, but permits the loan to be made sometimes through a lead bank, under a participation, because the lead bank may be an exempt lender under those usury or lending restrictions.

Mr Cam Johnston will explain too it can be used to avoid a withholding tax problem in some circumstances.

Other advantages include that if the extension of credit to the borrower will be continuing but the participants are expected to change, it is obviously easier to establish the credit between the borrower and the lead bank and then have the lead bank sell off the participations to various others from time to time.

Further, there is the question of security or collateral, and sometimes the holding or foreclosing on such collateral may be legally difficult or impossible unless it is managed in the hands of one lead bank.

Now finally, just one general problem that applies equally to syndications and participations, but I think sometimes more so in participations, relates to the disclosure of information relating to a bank customer's circumstances that should normally be kept confidential. This is a problem of course in selling participations, because some information has to be given. It can also be a problem subsequently in the handling, particularly if inside information that comes to a lead bank or an agent bank is relevant perhaps to a breach of covenant or some provision in the agreements, where there may be a fiduciary obligation, to consider passing that on to the participating banks. Obviously documentation, as I am sure you all know in these circumstances, sometimes provides various remedies, but remedies such as resignation of the lead or agent bank are fairly drastic remedies that are not practical and not welcomed by everybody. The most practical solution, of course, is to convince the borrower to make the disclosure, but again, sometimes that is not possible.

So I think there are some benefits, there are some problems, with both syndications and participations, but both techniques clearly will continue to be used to advantage, particularly in circumstances where there is a need to share risk, or there is a need to syndicate, to fulfil substantial needs.