

# ASSIGNMENT AND SUB-PARTICIPATION AGREEMENTS—A BASIC OVERVIEW

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*Assignments or sub-participation agreements with respect to loans are today standard transactions between banks. The author therefore thought it would be useful to analyse various legal aspects of these types of transactions, including some of the terms and conditions usually included in them. The first part of the article examines assignment and sub-participation agreements in light of the purposes being pursued by the parties and of the recourse available to an assignee or a sub-participant against the borrower. The second part of the article is devoted to a detailed analysis of the terms and conditions which are usually found in any assignment or sub-participation agreements. Finally, the article concludes with a short discussion of the legal nature of sub-participation agreements based on some recent decisions in the United States.*

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*Considérant que la cession et la vente d'une ou de plusieurs sous-participations dans un prêt sont devenues aujourd'hui des opérations interbancaires courantes, l'auteur a jugé intéressant d'analyser certains aspects juridiques ainsi que les termes et conditions relatifs à ce type de transaction bancaire. Dans cette perspective, une première partie de cet article sera consacrée à une analyse des contrats de cession et de sous-participation en fonction des buts recherchés par les parties et en fonction des recours du cessionnaire ou du sous-participant contre l'emprunteur. Une deuxième partie de cet article est consacrée à une étude détaillée des termes et conditions généralement rencontrés dans toute convention de cession ou sous-participation. Enfin, une brève analyse de la nature juridique des contrats de sous-participation à la lumière de récentes décisions américaines tient lieu de conclusion à cet article.*

## Introduction

The terms "assignment" and "sub-participation"<sup>1</sup> are commonly used today in the banking community. This is not surprising considering the large increase in recent years of the volume of these inter-bank transactions in the secondary market. This renewed interest in the assignment and sub-participation of loans, which have actually been standard inter-bank transactions for many years, can be explained in many ways.

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<sup>1</sup> The terms "participation" and "sub-participation" are sometimes used indiscriminately; however, the latter expression is more appropriate when referring to an agreement whereby a lead bank sells and transfers to a sub-participant, on a silent basis and without recourse, some or all of its credit risk under an existing loan facility, as opposed to a "participation" which normally represents the original commitment and loan by a bank as expressed in a syndicated credit agreement.

Firstly, the sale of sub-participations in existing loans can result, for the selling or lead bank, in the enhancement of its return on assets. This increased profitability can be achieved if the lead bank is able to sell, in whole or in part, to a purchasing bank, a loan which has a remaining life shorter than its original maturity, on terms (for example as to spread or fees) more favourable than originally set forth in the loan agreement. Thus, the difference between the rate of interest, including the spread or margin, negotiated at the beginning of the medium or long-term loan and the rate of interest on the sub-participation, which could be lower considering the shorter maturity of the existing loan being sold, is retained by the selling bank.<sup>2</sup>

Secondly, assignment and sub-participation transactions are interesting mechanisms used by banks to reach desired liquidity levels. By selling some of its existing assets, the lead bank can obtain additional cash without necessarily losing a valued relationship with its customer.

Sub-participations can also be used as another method of syndicating a large loan and sharing with other banks the credit risk involved, without such banks being party to the original credit agreement.<sup>3</sup>

Finally, assignments and sub-participations are used to solve the problems of overline that can occur from time to time. If a loan to one borrower exceeds the lending limit of the bank, whether set by the policy of its board of directors or imposed by statute or regulation, the bank can simply sell a portion of that loan and transfer the related credit risk to another bank or financial institution.<sup>4</sup>

Even though assignment and sub-participation transactions usually involve large sums of money to accommodate business relationships or marketing strategies, the written agreements relating to such transactions are not always drafted with the necessary legal precision. If the rights and duties of each party are not being clearly provided for the result is that a

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<sup>2</sup> For a detailed analysis of how such an increase of profitability and of return on assets can be obtained by the lead bank through the sale of sub-participations, see: Robert P. McDonald, *International Syndicated Loans*, Euromoney Publications Limited (1982), p. 202.

<sup>3</sup> Brian W. Semkow, *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks* (1984), 18 *The International Lawyer* 869, at p. 873; Ian F.G. Baxter, *International Financial Markets and Loans: An Introduction to the Legal Contract* (1985), 10 *Can. Bus. Law Jo.* 198, at p. 210; Phillip R. Pollock, *Notes Issued in Syndicated Loans: A New Test to Define Securities* (1977), 32 *Business Lawyer* 537; P. Wood, *Law and Practice of International Finance* (1984), pp. 11-30.

<sup>4</sup> Eric G. Behrens, *Classification of Loan Participations Following the Insolvency of a Lead Bank* (1984), 62 *Texas Law Rev.* 1115, at p. 1121; Semkow, *loc. cit.*, footnote 3, at p. 873; N. Easton, *Upstream Banks Learn Hard Lesson*, *Legal Times*, Monday, July 30, 1984, 1.

very satisfactory business transaction can be jeopardized by inadequate legal documentation. Accordingly, a review of the basic terms and conditions of any assignment and sub-participation agreement relating to existing loans, is also the subject of this article.<sup>5</sup>

### I. *Assignment and Sub-Participation Compared*

As it has been already noted,<sup>6</sup> the delivery and endorsement, with or without recourse, of a negotiable instrument constitutes the easiest means by which a lead bank can assign and transfer its rights under a loan to another bank. However, syndicated loan agreements do not always provide for issuance of promissory notes by the borrower in consideration of the advances made by the participating lenders. If promissory notes are issued, they will sometimes be made for the full amount of the loan and be payable to the order of the agent bank, with no separate notes being issued directly to each lender.

Furthermore, even if a promissory note is issued to each particular lender and even if the loan agreement provides for the replacement of the notes being sold and assigned by the issuance of new notes to the lead bank for the unsold portion of its loan and to the purchasing bank for the purchased portion of the said loan, it is doubtful if an endorsement of such promissory note will alone suffice for the purpose of achieving a valid and legal transfer of rights. Generally, such notes expressly provide that they are subject to the terms and conditions of the credit instrument under which they are issued, and the provisions for the payment of principal and interest are not dealt with in such promissory notes other than by a simple reference to the relevant provisions of the loan agreement. Clearly, in a Canadian context such evidences of indebtedness will not be considered as a negotiable instrument under the Bills of Exchange

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<sup>5</sup> The question whether or not participation and sub-participation are securities will not be dealt with in this article. This matter has been of some concern in the United States, and it has been suggested that some participations or sub-participations could be qualified as securities under the U.S. Securities Act (1933) or the U.S. Securities Exchange Act (1934); see: M.A. LeCompte, *International Loan Syndications, the Securities Acts and the Duties of a Lead Bank* (1978), 64 *Virginia Law Rev.* 897; M.T. Janik, *The Colocotronis Dispute: When is a Loan Participation Share a Security* (1978), 13 *Jo. of Int. Law and Economics* 165; David Z. Nirenberg, *Note: International Loan Syndications: The Next Security* (1984), 23 *Columb. Jo. of Transnational Law* 155; Naran U. Burchinow, *Liabilities of Lead Banks in Syndicated Loans under the Securities Acts* (1978), 58 *Boston Univ. Law Rev.* 45; Manon Pomerleau, *Les devoirs de la responsabilité de la banque chef de file dans la mise en oeuvre d'un prêt syndiqué international* (1985), 45 *R. du B.* 749; P. Wood, *op. cit.*, footnote 3, pp. 11-39; Pollock, *loc. cit.*, footnote 3, at p. 539; *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*, 409 F. 2d 989 (C.A. 5th Cir., 1969); *SEC. V.W.J. Howey Co.*, 328 U.S. 293 (1946).

<sup>6</sup> Pascale Bloch, *La sous-participation bancaire*, in J.B. Blaise, P. Fouchard and P. Khan, *Les Euro-Crédits; Un instrument du système bancaire pour le financement international* (1981), p. 243.

Act<sup>7</sup> since they do not contain an unconditional promise to pay a specified amount and, therefore, are not capable of being transferred by simple endorsement and delivery.

Consequently, a more formal document, in the form of an assignment or sub-participation agreement, should be entered into between the lead bank and its purchaser for the purpose of effectively transferring either certain rights and obligations and the related credit risk under the loan agreement or the credit risk alone.

In the event that the original lender wishes to transfer to another bank all or part of its rights and obligations under an existing loan agreement, together with the related credit risk of the borrower, a formal assignment agreement, as opposed to a sub-participation agreement, should be entered into between the lead bank and the assignee. This will relieve the lead bank from any further obligations under the loan agreement, such obligations being expressly assumed by the assignee, subject, however, to the consent of the relevant borrower, if required.

Even if the loan agreement contains express provisions permitting such an assignment of rights and obligations by the original lender, the consent of the borrower is usually sought by the selling and purchasing banks. The disclosed assignment of rights and obligations, together with the consent of the borrower, will then result in a true novation agreement.<sup>8</sup>

In the case where the original lender wishes to share the amount of the loan and transfer the related credit risk without modifying its contractual and banking relationship with the borrower, a sub-participation agreement, as opposed to a disclosed assignment agreement, represents the usual mechanism for achieving such purpose.

With a sub-participation, the borrower and in many cases the agent are unaware of the said transfer. This is often referred to as a silent sub-participation since two of the principal parties to the original loan contract have not agreed to the inclusion of the new lender. A short form loan contract is concluded exclusively between the two lenders and legal counsel will normally advise each party that all rights and obligations under the loan contract have not been transferred between lenders.<sup>9</sup>

In this respect, the basic forms of sub-participation will depend on whether the sub-participation is sold in the course of a syndication process<sup>10</sup> or sold after execution of the loan agreement for the reasons mentioned above.<sup>11</sup>

The most prominent methods of granting participations include assignments, sub-loans and undisclosed agency . . . Under a sub-loan, a participating bank makes a

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<sup>7</sup> R.C.S. 1970, c. B-5, s. 176.

<sup>8</sup> Wood, *op. cit.*, footnote 3, pp. 11-32; McDonald, *op. cit.*, footnote 2.

<sup>9</sup> McDonald, *ibid.*, p. 204.

<sup>10</sup> Which is referred to as a "participation syndicate"; Baxter, *loc. cit.*, footnote 3, at p. 210; Semkow, *loc. cit.*, footnote 3, at p. 873; Wood, *op. cit.*, footnote 3, pp. 11-30.

<sup>11</sup> *Supra*, footnote 1.

loan directly to the lead bank. The repayment of the loan is solely contingent upon the lead bank receiving payments from the borrower and is secured by the participating bank with an assignment of proceeds. With undisclosed agency, the lead bank forms the syndicate before the execution of the loan agreement, acting as the agent on behalf of the syndicate, but without disclosing this agency relationship to the borrower. The lead bank is liable for all obligations toward the borrower under the loan agreement, especially if the loan agreement expressly or by implication claims that it applies to the stated parties therein. The lead bank can neither claim that it is merely an agent nor have a participant intervene as a principal, a serious disadvantage in the event, for instance that any one of the participating banks were in default of advancing funds during the drawdown of the loan to the borrower.<sup>12</sup>

Such agreements can also contain undertakings by the sub-participant in favour of the lead bank to provide future amounts in the event that the loan is not fully disbursed at the date of the sub-participation or if the loan is a revolving credit facility.

Furthermore, a credit risk can be transferred by the lead bank and assumed by the sub-participant by way of guarantee (in the form of a letter of credit, letter of guarantee or bank draft) issued in favour of the lead bank. In this situation, no amount is actually disbursed by the sub-participant to the lead bank unless the borrower defaults under the original credit agreement. Upon the default of the borrower, the sub-participant is then obliged to advance its agreed share of the loan to the lead bank and then participate on a *pro rata* basis in any repayment made by the borrower to the lead bank or received through realization of security or otherwise.

Whether the sub-participation takes the form of an undisclosed assignment, agency or sub-loan agreement, or the form of a guarantee agreement, the principal characteristics remain the same. Both are referred to as "silent sub-participations" because the consent of the borrower is not sought nor required and the sub-participant generally undertakes expressly not to communicate with the borrower and the agent bank, if any, in the case of a syndicated loan.

The sub-participant does not become a party to the original credit agreement, and the legal relationship between the lead bank and the borrower remains unchanged. The lead bank is bound to make available to the borrower the full amount of its loan or commitment irrespective of any default of the sub-participant to provide its share of the loan. As regards the documentation, the original credit agreement and all security and other supporting documents remain in the name of the original lender.<sup>13</sup>

Consequently, the lead bank and its sub-participant are not co-lenders, and no legal contractual relationship is created between the borrower and

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<sup>12</sup> Semkow, *loc. cit.*, footnote 3, at p. 873.

<sup>13</sup> Behrens, *loc. cit.*, footnote 4, at p. 1122; Wood, *op. cit.*, footnote 3, pp. 11-30; Semkow, *loc. cit.*, footnote 3, at p. 873; Bloch, *op. cit.*, footnote 6, p. 247.

the sub-participant.<sup>14</sup> Thus, in *Yale Express System Inc.*,<sup>15</sup> a loan was entered into between Yale and First National City Bank ("First National"), and subsequently, a "participation agreement" was entered into between the latter and Marine Midland Trust Company of New York ("Marine"), providing that Marine was to take "an undivided 40% participation" in each advance to be made to Yale by First National, as the lead bank. Following the bankruptcy of Yale, Marine refused to pay over to the trustee a large amount deposited with Marine by Yale and attempted to impose set-off against the amount still outstanding and unpaid on the participation. Having examined the terms of the participation agreement, the court held that no creditor-debtor relationship could exist between Marine and Yale on the basis of the participation agreement, and, therefore, Marine was not a creditor entitled to set-off the amount held by it in Yale's account against the amount owed to it under the participation agreement. The court stated:<sup>16</sup>

... I find that the provisions of the participation agreement between Marine and FNCB, particularly when read in the light of the various agreements between Yale and FNCB, negate the existence of any such creditor status as Marine now claims. Simply stated, Marine advanced money only to FNCB. Repayment of any amount advanced to FNCB by it under the participation agreement was made or to be made by FNCB, and its right to repayment would arise only upon the receipt by FNCB of payment from Yale. All rights to extend or amend the substantial terms of the credit agreement were lodged solely with FNCB. Upon any default by Yale, FNCB alone had the power to act respecting such default or defaults. In addition, FNCB had the option to repurchase Marine's stipulated participation interest. Finally, it is not surprising to note that FNCB has made claim as a creditor for the entire amount of the loan to Yale remaining unpaid, including Marine's participation therein.

Similar reasoning was followed in France by the Cour d'Appel de Paris in *Bellat v. B.N.P.*,<sup>17</sup> where the Banque Nationale de Paris ("BNP") had purchased fifty per cent of the total amount of certain loans made by Union Francaise de Banque ("UFB") to Société Générale d'Impression, the borrower. It should be noted that BNP, the principal banker of the borrower, had previously obtained the full and unlimited guarantee of a shareholder of the borrower as security for any loan made by BNP to the borrower. Upon the bankruptcy of the borrower, BNP sought to recover its loss against the shareholder that had guaranteed the repayment of any loan made by BNP to the borrower. To succeed against the guarantor, BNP had to show that the sub-participation purchased from UFB was in fact a loan made by BNP to the borrower. Noting that the borrower was

<sup>14</sup> Wood, *op. cit.*, footnote 3, pp. 11-34; McDonald, *op. cit.*, footnote 2, p. 204; Behrens, *loc. cit.*, footnote 4, at p. 1123; Bloch, *op. cit.*, footnote 6, p. 251; LeCompte, *loc. cit.*, footnote 5, at p. 899; Burchinow, *loc. cit.*, footnote 5, at p. 45; Janik, *loc. cit.*, footnote 5, at p. 169.

<sup>15</sup> 245 F. Supp. 790 (N.Y. Dist. Ct., 1965).

<sup>16</sup> *Ibid.*, at p. 792.

<sup>17</sup> Gazette du Palais, 1975-2-727.

unaware of the sub-participation agreement between UFB and BNP, the court could not find any support in the agreement for the existence of a direct creditor-debtor relationship between BNP and the borrower. The sub-participation could not be characterized as a loan from BNP to the borrower and, therefore, was not secured by the guarantee previously given by the shareholder to BNP.

Finally, it should be noted that disclosed assignment and sub-participation agreements are usually entered into for a period extending to the maturity of the original loan. However, they can sometimes be executed on a short-term basis, that is the assignment or sub-participation agreement can expire before the final maturity of the loan. In such a situation, repurchase provisions contained either in the assignment or sub-participation agreement or in a separate agreement are necessary to take into account the conditions upon which the loan being assigned or sub-participated will be repurchased by the lead bank.

Since one of the reasons for entering into any assignment or sub-participation is to transfer part or all of a credit risk to the purchasing bank, the repurchase provision will normally only take effect if on the date of the repurchase, the borrower is not in default under the original credit agreement. If default has occurred, the lead bank is generally not obliged and is not bound to repurchase the amount so assigned or sub-participated, and its obligation to repurchase is then suspended until the default is effectively cured or a refinancing agreement is entered into between the lead bank and the borrower. Unless such conditions take place, there will be no repurchase, and the assignee or the sub-participant will then have to support its share of the loan until the loan is fully repaid by the defaulting borrower and if not repaid, it will assume its share of the loss resulting from such failure of the borrower.<sup>18</sup>

## II. *Conditions Precedent to Assignment and Sub-Participation*

The conditions precedent before any disclosed assignment or sub-participation can effectively occur are to be found in the original credit agreement and in the assignment or sub-participation agreement itself.

The credit agreement should always be carefully examined, since it is normal practice to insert provisions with respect to the ability of any

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<sup>18</sup> Assignment or sub-participation agreements will provide for the rate and computation of interest that the purchasing bank is entitled to receive up to repurchase; however, sometimes such agreements provide for a fixed rate of interest which is different from the rate of interest provided for in the original credit agreement. Consequently, in the latter case, it is important to note that if default by the borrower occurs prior to repurchase and consequently no repurchase effectively takes place, the provisions with respect to computation of interest and the new rate of interest to come into effect after the proposed termination date of the agreement if no repurchase takes place should be inserted at the outset of the assignment or sub-participation agreement.

lender to assign its rights and obligations under such agreement. There are many variations of such provisions depending upon the financial situation and negotiating strength of the borrower, the size of the loan and the way such loan was originally syndicated. However, the basic provision usually reads as follows:

Each Bank may at any time assign or transfer all or any part of its rights or obligations hereunder without the prior written consent of the Borrower to any other bank or financial institution. Each Bank shall promptly thereafter give notice thereof to the Agent who will then forthwith give notice thereof to the Borrower. Each Bank may disclose to any potential assignee or to any person who may otherwise enter into contractual relations with such Bank in relation to this Agreement, such information about the Borrower as such Bank shall consider appropriate.

Other variations of this clause will not allow lenders to assign all or any part of their rights and obligations without the prior written consent of the borrower. Some will only require prior written consent of the borrower with respect to the assignment of obligations.

Problems can also arise when the assignment provision in the original credit agreement does not permit the lender to communicate the relevant financial information relating to the borrower to a prospective assignee or sub-participant. If such documents are not publicly known or available, the consent of the borrower allowing the selling bank to communicate any such information should be obtained to avoid any breach of confidentiality with respect to the bank-client relationship.

Conditions precedent are normally provided for in any disclosed assignment or sub-participation agreement, and subject to such conditions, these agreements become effective when:

- (1) payment is made by the purchasing bank to the selling bank of the agreed share of the outstanding principal amount of the loan which is being assigned or sub-participated; and
- (2) in the case of a disclosed assignment agreement the selling bank delivers an assignment notice to the borrower and to the agent bank, if any, advising as to the nature of the assignment (assignment of rights or assignment of rights and obligations) and the amount of such assignment, and the assignee delivers to the borrower and agent bank its written undertaking to be bound by the terms and conditions of the loan agreement up to the extent of the assigned amount. Both notices will normally provide for an express acceptance by the borrower and the agent bank and, if obligations are being assumed by the purchasing bank, for the release of the selling bank with respect to such obligations. Such acceptance will read:

We hereby acknowledge receipt of a letter [dated] from the (assignor or assignee) of which this is a duplicate, and we hereby confirm that we have received due notice of and we agree to the assignment and transfer therein referred to. We hereby agree that the assignee is a bank for all purposes of the loan agreement and that all the rights and obligations of the assignor thereunder in respect of the assigned amounts are now terminated.



The purchasing bank should receive prior to the effective date of the assignment or sub-participation agreement, the credit agreement and all of the other related documentation. With respect to a disclosed assignment agreement, if one or more notes are held by the selling bank but cannot be endorsed over to the purchasing bank because it only has a partial interest in any such note and no new note can be obtained from the borrower, then provisions should also be added to provide that the selling bank will, up to the extent of the assigned amount, hold any such note for the benefit of the said purchasing bank.

If all the conditions precedent are met, then the assignment or the sub-participation agreement becomes effective, and the legal relation between the selling bank and purchasing bank will be governed by the various terms and conditions provided for in the said agreement.

### III. *Terms and Conditions*

Even though assignment or sub-participation agreements can be drafted in a variety of ways, basic provisions should always be provided for to avoid any ambiguities or disputes which could conceivably damage an otherwise very satisfactory business relationship between the selling bank and the purchasing bank. The basic terms and conditions could be summarized as follows.

#### A. *Undertakings of the Purchasing Bank*

In disclosed assignment agreements, the only undertaking really necessary is the acknowledgement by the assignee that it is bound by the terms and conditions of the agreement, and, when obligations are being assigned, the undertaking of the assignee to assume such obligations for the benefit of the selling bank.

In sub-participation agreements, it is also essential that the sub-participant undertake in favour of the lead bank to be bound by the terms and conditions of the loan agreement so that any obligation imposed on the lead bank can in turn be imposed on the sub-participant.<sup>19</sup>

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<sup>19</sup> This undertaking is imperative in case of a syndicated loan considering the "pro rata sharing" provisions usually found in syndicated loan agreements. If payments are received by one lender and not by other members of the syndicate, then the lender is under a contractual obligation to remit the entire amount paid to the agent for the purpose of sharing such amount on a *pro rata* basis with the other co-lenders. Thus, if the amount received at the outset has already been paid to the sub-participant, the lead bank has to be in a position to request the sub-participant to repay the amount it has received in order to allow the former to share the entire amount with the other co-lender members of the syndicate. On the "pro rata sharing" provisions in syndicated loan agreements, see: Wood, *op. cit.*, footnote 3, pp. 11-29; Semkow, *loc. cit.*, footnote 3, at p. 912; Baxter, *loc. cit.*, footnote 3, at p. 210.

Furthermore, as mentioned previously,<sup>20</sup> the sub-participant must undertake not to communicate with the borrower or the agent in relation to such sub-participation, if the agreement is intended to be a truly silent sub-participation.

Finally, the sub-participant must also undertake to indemnify the lead bank for any costs and expenses resulting from the enforcement of any rights under the credit agreement, including realization of any collateral. The lead bank will usually provide for a right of set-off for such *pro rata* share of the costs and expenses against any amount of principal and interest to be paid by the lead bank to the sub-participant.

### B. Representations and Warranties

The representations and warranties made by the selling bank in disclosed assignments or sub-participations are limited, since the whole purpose is to transfer the credit risk of the borrower to the purchasing bank. Therefore, the selling bank will not make any representations and warranties with respect to the following:

- (1) the due execution, legality, validity, adequacy or enforceability of the loan agreement and any other documents related thereto;
- (2) the accuracy or completeness of any documentation or any information supplied by the selling bank to the purchasing bank in connection with the loan documentation or the loan agreement;
- (3) the financial condition of the borrower; and
- (4) the performance by the borrower of its obligations under the loan agreement and any other documents relating thereto.

Furthermore, the selling bank will request the acknowledgement by the purchasing bank that it has itself been and will be solely responsible for making its own independent appraisal of any investigation into the financial condition and credit-worthiness of the borrower and has not relied on the selling bank to appraise or keep under review on its behalf the financial condition and credit-worthiness of the borrower.<sup>21</sup>

The only representation and warranty normally given by the selling bank will relate to its right and power to enter into the assignment or the sub-participation agreement and to its good and valid title in the loan being assigned or sub-participated.

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<sup>20</sup> See *supra*, at footnote 6.

<sup>21</sup> The inclusion of this provision is, in the United States, quite advisable in light of a recent policy statement issued by the Office of the Comptroller of the Currency stating that the purchasing bank that "fails to make such a determination could be subject to administrative sanction". See: Easton, *loc. cit.*, footnote 4; see also L. Brenner, Comptroller's Ruling May Kill Loan Sale Tack, *American Banker*, June 3, 1985, 3.

Under sections 18(1), 20(1) and 173 of the Bank Act,<sup>22</sup> assignments and sub-participations of loans are permitted banking transactions, subject, however, to the provisions of section 190(8) and (9). These subsections read:

- (8) Nothing in this Act prevents a bank from acting in consort with or from associating itself with a consortium or syndicate of financing or lending institutions to effect a loan notwithstanding that such action may result in Canada in the private placement by the bank or in one or more transactions by the bank and others, if no less than one-half of the total principal amount of the loan is advanced by the bank together with one or more other banks or foreign banks.
- (9) Where a bank participates in effecting a loan as permitted by subsection (8), the bank may not sell or transfer any instrument of indebtedness or interest in such an instrument that such bank acquires by reason of such participation to any person other than another bank or foreign bank that also participates in effecting the loan, or a guarantor, if any, of the loan, during the two-year period following the day the bank acquires the instrument of indebtedness or interest.

There is no doubt that subsection (8) permits syndication of a loan by way of a participation syndicate.<sup>23</sup> However, for the lead bank not to be deemed as acting as an underwriter in Canada in contravention of subsections (5) and (7) of section 190 of the Bank Act, it would be advisable that the sub-participants who are to become members of the participation syndicate be known at the time of execution of the loan agreement by the lead bank.

There may be some concern as to how a loan transaction should be structured so as to meet the requirements of subsection 190(8). In acting as the lead in a lending transaction involving a number of lending institutions, a bank may in the first instance acquire the loan for itself and then subsequently sell participations to others. If it does this under circumstances where the documents and the structure of the transaction clearly contemplate the resale of participations, the bank would be either acting as an underwriter or otherwise acting in effecting a private placement and would be free to do so if it complied with subsection 190(8). On the other hand, if the bank merely acquired the securities evidencing the loan for itself in the first instance it is difficult to say that it was acting "in concert with" or "associating itself with" a consortium or syndicate or other institutions. Accordingly, it would appear to be necessary for the transaction to be structured so that the institutions to which the bank would be reselling participations would be identified at least by the time the loan was made, even though technically the loan might be committed in the first instance by the bank and subsequently portions assigned to the other institutions.<sup>24</sup>

However, if some of the sub-participating banks were not known at the date of execution of the loan agreement, any sale of sub-participation within the two-year period after such date to banks other than those already party to the participation syndicate might cause the lead bank to

<sup>22</sup> S.C. 1980-81-82-83, c. 40. See also *Re Canadian Deposit Insurance Corp. and Canadian Commercial Bank* (1986), 27 D.L.R. (4th) 229 (Alta. Q. B.).

<sup>23</sup> See *supra*, at footnote 5.

<sup>24</sup> John H.C. Clarry, *Dealing in Securities—Bank Act Provisions and Regulatory Issues*, in *Important New Developments, Banking Law and Practice*, Insight Conference held on November 12, 1984, in Toronto.

be acting as an underwriter. It should also be noted that the reselling prohibition during the two-year period set forth in section 190(9) would apply to any bank which is party to the participation syndicate.

The scope of section 190(8), with respect to a bank which makes a loan for its own account with no syndication or assignment provisions in the loan agreement, is not clear when such bank subsequently enters into one or more assignments or sub-participation agreements relating to the loan. If the bank has entered into the loan agreement with a view to distributing the loan and the related securities (for example promissory notes or debentures) by way of assignment or sub-participation, then the bank could conceivably be acting as an underwriter.<sup>25</sup>

The situation is even less clear when the bank has not entered into the loan agreement with a view to assigning or selling participation in the loan and related securities.

Substantially the question will be whether the bank acquired the securities in the first instance in a *bona fide* loan transaction, intending to hold the securities as part of its own portfolio, and subsequently by reason of a change in circumstances determined that it wished to dispose of all or a portion of the loan. While a bank might be able to justify its action on this second ground in any particular case, if a bank made a practice of entering into transactions of this kind it might be difficult to rebut the conclusion that indirectly it was acting as underwriter and effecting private placements.<sup>26</sup>

Consequently, in light of section 190(8) and (9), a lead bank in Canada should always be satisfied that when entering into an assignment or sub-participation agreement it is not acting as an underwriter.

### C. *Payment of Principal and Interest*

The provisions relating to the payment of principal by the lead bank to the purchasing bank are not necessary in a disclosed assignment agreement, since after the notice is given to the borrower, the latter will pay directly to the assignee its share of any repayment of principal.

In sub-participation agreements, it is necessary to include specific provisions dealing with this matter. As mentioned earlier,<sup>27</sup> the lead bank is normally not obliged to make any principal payment to the sub-participant unless and until such payment of principal has been received from the borrower. Furthermore, depending upon the agreement, payments by the borrower may be shared between the lead bank and the sub-participant on a *pro rata* basis, or can be applied in priority in reduction of the loan not being the object of the sub-participation and after in reduction of the

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<sup>25</sup> *Ibid.*, at p. 28. See also the definition of "underwriter" under section 190(1) of the Bank Act, *supra*, footnote 22.

<sup>26</sup> *Ibid.*, at p. 29.

<sup>27</sup> See *supra*, pp. 227-228.

sub-participation. However, after default such payments are normally shared on a *pro rata* basis.

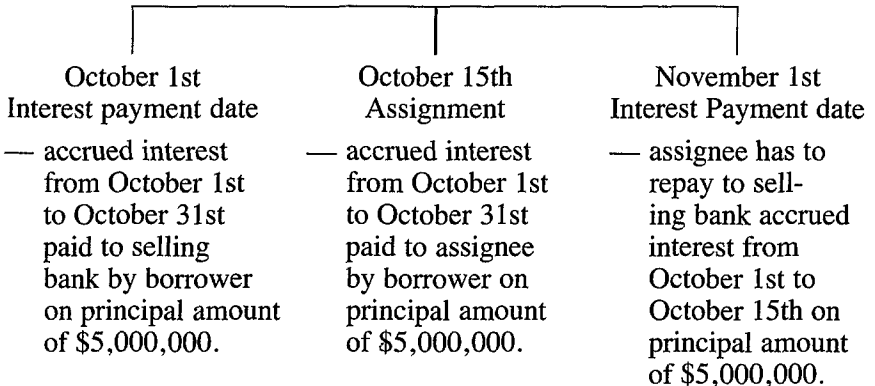
Finally, in syndicated loan agreements, it is usual to find provisions to protect the agent bank for payments made to the lenders for the account of the borrower in the event that the agent is not paid concurrently by the borrower for the full amounts disbursed to the lenders. If the borrower fails to pay the agent the full amount owed to the lending syndicate, upon request from the agent, each lender is bound under the credit agreement to repay to the agent its *pro rata* share of any amount which was paid beyond the amount actually received from the borrower by the agent. In such an event, the lead bank which is asked to remit to the agent any amount should, in turn, be in a position to require its sub-participant to remit its share of such repayment.

The provisions relating to the payment of interest are for all purposes the same as for the payment of principal. Therefore, no such provisions are necessary in a disclosed assignment with the exception of provisions dealing with accrued interest on the loan being assigned. With respect to such accrued interest, if the date upon which an assignment becomes effective does not correspond to an interest payment date under the loan agreement, it is of importance for the selling bank to ascertain that the accrued interest owed to it will be received after the assignment has taken place.

Since the borrower is bound to make all payments of interest and principal to the assignee after notice of the assignment, the selling bank must impose on the assignee the obligation to repay the amount of accrued interest upon receipt from the borrower of such amount on the next interest payment date. This could be summarized as follows:

Amount of the loan: \$10,000,000.

Amount being assigned: \$5,000,000.



It should be noted that the rate of interest on any sub-participation will, depending on the agreement, be equal to the rate received by the lead bank on the loan or will sometimes be at a slightly lower rate if the sub-participation is not sold up to the maturity of the loan, or, if sold up to the maturity of the loan, it is sold for a remaining period which is less than the original life of the loan.

Furthermore, computation of interest on the sub-participation should be in accordance with the provisions of the credit instrument so that the lead bank is not assuming greater liability to its sub-participant than the borrower to the lead bank. If such provisions of computation of interest under the sub-participation agreement are to be a mirror image of the interest provisions of the credit agreement, it is important to bear in mind that if the sub-participation is governed by Canadian law, the annual rate of interest should be disclosed or the equivalent should be given on the basis of a 365-day year. However, since most of the international syndicated loans and some domestic loans are based on the London Interbank Offered Rate (LIBOR) which is computed on the basis of a 360-day year, a provision to take this into account should be added. This is deemed advisable in light of section 4 of the Interest Act<sup>28</sup> which reads:

4. Except as to mortgages on real estate, whenever an interest is, by the terms of any written or printed contract, whether under seal or not, made payable at a rate or percentage per day, week, month, or at any rate or percentage for any period for less than a year, no interest exceeding the rate of percentage of 5% per annum shall be chargeable, payable or recoverable on any part of the principal money unless the contract contains an express statement of the yearly rate of percentage of interest with such other rate or percentage is equivalent.

However, the use of a formula to express in annual terms the interest rate in the loan agreement where the LIBOR is used should be sufficient to meet the requirements of section 4. It has been suggested that:

... the correct manner to annualize an interest rate based on a 360-day year would be to divide the interest rate in question by 360 and then multiply it by 365 (or 366 in the case of a leap year). Accordingly, a clause similar to the following, inserted in all loan agreements where the rate of interest is based on a 365-day year, should bring compliance with Section 4:

"The yearly rates of interest to which the rates determined in accordance with this agreement are equivalent, are the rates so determined divided by 360 and multiplied by the actual number of days in the year".<sup>29</sup>

In *V.K. Mason Construction Limited v. Courtot Investment et al.* and *V.K. Mason Construction Limited v. Bank of Nova Scotia et al.*<sup>30</sup> the loan agreement between Courtot (the borrower) and the bank provided for

<sup>28</sup> R.S.C. 1970, c. I-18.

<sup>29</sup> Stuart H. Cobbett, *Loan Agreements—Interesting & Demanding*, in *New Developments in Commercial Lending* (1981), Meredith Memorial Lectures 314, pp. 318-319.

<sup>30</sup> [1985] 1 S.C.R. 271.

a standard LIBOR clause without providing the equivalent on a yearly basis. The trial judge found that section 4 applied:<sup>31</sup>

. . . by the terms of a written agreement between the Bank and Courtot, Courtot was to pay interest at a rate or percentage for a period less than a year and the contract does not contain an express statement of the yearly rate of interest Courtot was being charged.

The decision of the trial judge was, however, reversed by the Supreme Court of Canada. The court decided that the loan between the bank and Courtot was a mortgage on real estate and, therefore, escaped the application of section 4. However, Wilson J., rendering judgment for the court, went on to state that:<sup>32</sup>

Furthermore, I believe that the bank's interpretation of S.4 is much more in accord with the legislative purpose of the *Interest Act*. Section 4 is consumer protection law in the sense that with respect to loans other than real estate mortgages, consumers are entitled to know the annual rate of interest they are paying. A sophisticated commercial borrower like Courtot, who in this case was borrowing at a floating rate of interest, is in scant need of protection by being informed of the rate of interest at the annual, rather than the 360-day rate.

Consequently, one can question the necessity of inserting a clause providing for the calculation of the annual rate in a sub-participation based on the LIBOR between two banks who are evidently not consumers and who can calculate the annual rate themselves. However, the comments of Wilson J. being *obiter dictum*, it would be more prudent to maintain the use of such clause in a LIBOR financing and any related sub-participation agreement.

#### IV. Discretionary Rights

Discretionary right provisions are only found in sub-participation agreements and the purpose is to determine the scope of the power that the lead bank will retain with respect to the original credit instrument. Such a clause usually reads:

The bank is and shall remain entitled to:

- (i) exercise or refrain from exercising any or all of its rights and powers arising or in connection with the loan agreement or any document relating thereto; and
- (ii) agree to any amendments or waiver of the terms of the loan agreement or any document relating thereto;

provided that in exercising or refraining from exercising such rights and powers or agreeing to such amendment or waiver, the bank shall have regard to all relevant circumstances, including the interest of the sub-participant, and the bank shall not be entitled under this section to agree to any such amendment or waiver which would directly result in the reduction of the rate of interest or of the principal amount of the loan otherwise than by repayment.

In the event that the consent of the sub-participant is required when amendments to the credit agreement relate to the rate of interest or the

<sup>31</sup> (1980), 10 B.L.R. 77, at p. 109 (Ont. S.C.).

<sup>32</sup> *Supra*, footnote 30, at p. 287.

reduction of principal payment; there is always the possibility of disagreement between the lead bank and its sub-participant. Since the lead bank has to vote on such amendment for the full amount of its loan, it is put in a situation where the only option available is either to repurchase the sub-participation or to vote in the manner requested by the sub-participant for the full amount of the loan even if the lead bank has an opposite view as regards its own portion of the loan.

#### V. *Legal Nature of Sub-Participation*

In conclusion, a few words with respect to the legal nature of sub-participation might be in order. This determination becomes necessary in case of the insolvency of the lead bank, since the character of the contractual relationship between the sub-participant and the lead bank will determine the nature of the claim of the sub-participant in the liquidation process of the assets of the lead bank.

It is recognized that the legal nature of sub-participation is still an open question.<sup>33</sup> A brief review of American decisions shows that sub-participation agreements have not been uniformly defined in the United States. It has been suggested that sub-participation agreements can be interpreted as being a debtor-creditor relationship between the lead bank and its sub-participant.<sup>34</sup> This interpretation is based on the fact that since the lead bank does retain the loan documentation and retains full control over the loan, the intention of the parties must have been to have a loan from the sub-participant to the lead bank which loan is repayable by the lead bank only upon the lead bank receiving its own payment from the borrower.

Others have suggested that the sub-participation can be classified as follows:

A trust or fiduciary arrangement in which the upstream bank purchases an indirect property interest in the participated third-party loan. . . Proponents of this view stress the principle of agency, assignment and trust. The lead bank's retention of loan documentation and collection and distribution of loan payments signify the correspondent present assignment of a property interest in the third-party loan with an agency that allows the originating lender to collect payments. Alternatively, proponents of this classification scheme treat the participation as an express trust

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<sup>33</sup> See Essay, *The Aftermath of Penn Square Bank: Protecting Loan Participants from Set-Offs* (1983), 18 *Tulsa Law Jo.* 261, at p. 262: "Although the use of loan participations is by no means new to the financial world, this type of transaction has yet to be defined as a matter of law"; see also Behrens, *loc. cit.*, footnote 4, at p. 1121; Wood, *op. cit.*, footnote 3, pp. 11-34; and see the comments *supra*, pp. 227-228.

<sup>34</sup> *Yale Express Systems Inc.*, *supra*, footnote 15; see also *In Re Alda Commercial Corp.*, 327 F. Supp. 1315 (N.Y. Dist. Ct., 1971); Behrens, *loc. cit.*, footnote 4, at p. 1122.



under which the lead bank acts as a trustee for the correspondent or as a present assignment with trust to collect.<sup>35</sup>

Therefore, if a trust relationship can be created, the sub-participant is entitled to receive from the receiver of the lead bank its share of any payment of interest or principal made by the borrower.

However, even if some United States courts have been willing to consider a trust relationship between the lead bank and its sub-participant, such a trust relationship has, nevertheless, been rejected in other cases. In most instances one of the basic requirements to create a trust was not met, namely that the lead bank's funds be "directly augmented by the amount in trust",<sup>36</sup> and that "the trust must be traceable all the way into the hands of the receiver before the participant may withdraw from the liquidated assets".<sup>37</sup>

Thus, in *Federal Deposit Insurance Corporation v. Mademoiselle of California*,<sup>38</sup> the lead bank, San Francisco National Bank, had sold to Union Bank eighty per cent of a promissory note in the amount of \$60,000 issued by Mademoiselle to the lead bank; incidentally, no notice of assignment and transfer in the note was given to Mademoiselle. On the bankruptcy of San Francisco National Bank, Union Bank opposed the set-off which Mademoiselle intended to make of the borrowed amount against the deposit it had with the lead bank. Even though the court noted that "circumstances must suggest a trust",<sup>39</sup> it was held that the claim of Union Bank must fail since one of the requirements noted above was not met. The set-off of the deposit against the note did not increase the insolvent estate of the San Francisco National Bank and, therefore, did not constitute funds upon which the correspondent could say it augmented the amount in trust.

The decision of *Mademoiselle of California* has been more recently affirmed by two other decisions. In *Hibernia National Bank v. Federal Deposit Insurance Corporation*,<sup>40</sup> a certificate of participation sold by Penn Square Bank to Hibernia read:

We hereby confirm that in consideration of your payment to us, we are holding for your account a pro rata interest on the unpaid principal of the subject note with the same proportionate interest in any and all interest to accrue on the note . . .<sup>41</sup>

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<sup>35</sup> Behrens, *ibid.*, at p. 1122; see also *Stratford Financial Corp. v. Finex Corp.*, 367 F. 2d 569 (C.A. 2nd Cir., 1966).

<sup>36</sup> Behrens, *ibid.*, at p. 1128.

<sup>37</sup> *Ibid.*

<sup>38</sup> 379 F. 2d 660 (C.A. 9th Cir., 1967).

<sup>39</sup> *Ibid.*, at p. 664.

<sup>40</sup> 733 F. 2d 1403 (C.A. 10th Cir., 1984).

<sup>41</sup> *Ibid.*, at p. 1409.

The court held that the certificate of participation could not be characterized as a trust agreement, since Hibernia was not able to identify a specific fund in the possession of the receiver "cognizable in equity as Hibernia property".<sup>42</sup> The court also noted that Hibernia was not a creditor of the borrower and could look solely to Penn Square Bank or the Federal Deposit Insurance Corporation as its receiver for the satisfaction of its claim. A similar result was achieved in *The Chase Manhattan Bank, N.A. v. Federal Deposit Insurance Corporation*,<sup>43</sup> also involving Penn Square Bank as lead bank under a certificate of participation.

Whether the Canadian courts will follow these decisions remains to be seen. In a recent decision, *Re Canadian Commercial Bank*,<sup>44</sup> the court, after reviewing briefly various sub-participations entered into by The Canadian Commercial Bank as the lead bank, stated, with little explanation, that these agreements were in the nature of a sale (The Canadian Commercial Bank as the vendor and the participant as purchaser), implemented by a trust mechanism. The characterization of a sub-participation agreement will obviously vary greatly, depending on the intention of the parties and on the wording used in the agreement. However, it might be said that generally in a sub-participation agreement the lead bank does not intend to act as a trustee for the benefit of the sub-participant. Whether a sub-participation agreement under Canadian law will be characterized as an assignment, undisclosed agency, a trust or a loan is still an unanswered question, notwithstanding the decision in the *Canadian Commercial Bank* case.

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<sup>42</sup> *Ibid.*, at p. 1408.

<sup>43</sup> 554 F. Supp. 251 (Okla. Dist. Ct., 1983).

<sup>44</sup> [1986] 5 W. W. R. 531 (Alta Q. B.).