

Participation agreement through the lens of debt theory

The concept of a loan participation represents the practice of financial institutions of dividing up or sharing a loan. The loan is typically made by one party (the originating lender), who then transfers a percentage of this loan to another financial institution (the participant).¹ A participation agreement specifically regulates the relationship between the originating lender and the participant.²

One of the most debated analyses for the legal nature of the participation agreement is a debt theory. It maintains that the participation agreement creates a creditor-debtor relationship whereby the participant lends money to the originating lender on the security of the underlying loan.³

Consequently, the participant can claim repayment only from the originating lender and has no ownership interest in the underlying loan provided to the borrower. Moreover, the participant can be classified as a creditor if the originating lender is declared insolvent.

There are several factors indicating the existence of a creditor-debtor relationship:

- (1) the originating lender guarantees the payment of the principal and interest to the participant;
- (2) there are different payments between the underlying borrower and the originating lender on the one hand, and between the originating lender and the participant on the other;
- (3) the terms of a participation and the underlying loan are different, and
- (4) the interest rates payable on the underlying loan are different from those payable on the participation.⁴

The case of *Re Woodson Co, Fireman's Fund Insurance v. Grover*⁵ shows some of the above factors at play. The judgement was made in 1987 by the US Court of Appeals. The Woodson company was a mortgage broker in the business of making

¹ Kevin B. Fisher, & Elizabeth R. Muratet, *The Aftermath of Penn Square Bank: Protecting Loan Participants from Setoffs*, 18 Tulsa L. J. 1982. P. 264.

² Haynes A. *The Law Relating to International Banking*. Bloomsbury Publishing, 2018. – 104 p.

³ Mugasha A. *The Law of Multi-Bank Financing: Syndications and Participations*. McGill-Queen's University Press, 1997. P. 210.

⁴ Ibid. P. 217.

⁵ *Re Woodson Co, Fireman's Fund Insurance v. Grover*. 813 R zd 266 (9th Cir. 1987).

loans secured by real estate. Typically, it originated a loan and thereafter farmed out a fractional interest in the loan to an investor. The issue was whether the loans and the security were the property of the investors or the Woodson company. The court concluded that the legal nature of the participation agreements was that the participants made loans to the originating lender, so investors had no rights under the originating loans and collateral.

The similar issue was considered in the UK and was resolved in a different way. Today the most discussed decision in the UK academic literature is the case of *Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Limited*, where the Court of Appeal overturned a controversial High Court ruling based on the debt theory.⁶

In this case Kimura (the originating lender) entered into a participation agreement with Yieldpoint (the participant), under which the participant paid originating lender \$5 million for the purpose of further extension to the borrower. The borrower defaulted in February 2022. One month thereafter, the participant provided notice of its intention not to renew its participation and claimed repayment of the \$5 million.⁷

However, originating lender did not repay the claimed \$5 million of capital to the participant.⁸ The High Court held that the originating lender was liable in debt for \$5 million plus interest based on the debt theory.

The Court of Appeal reversed the High Court decision and found in favour of the originating lender. This judgment is also supported in the academic literature as more reasonable.⁹

In conclusion the debt theory may lead to unfair court decisions in case of the borrower's bankruptcy. So, the legal nature of the participation agreement is subject to further research.

⁶ Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Ltd [2024] EWCA Civ 639.

⁷ McDermott Will & Emery: <https://www.mwe.com/insights/the-uk-court-of-appeal-rules-on-the-interpretation-of-frankenstein-contracts/>

⁸ Herbert Smith Freehills: <https://www.herbertsmithfreehills.com/notes/bankinglitigation/2024-posts/Court-of-Appeal-dismisses-claim-by-participant-against-lender-of-record-in-a-sub-participation-arrangement>

⁹ Trade Finance Global: <https://www.tradefinanceglobal.com/posts/yieldpoint-v-kimura-victory-for-market-practice-or-just-a-warning-on-how-to-draft/>

Sources:

- 1) Haynes A. The Law Relating to International Banking. Bloomsbury Publishing, 2018. – 104 p.
- 2) Herbert SmithFreehills:
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- 3) Kevin B. Fisher, & Elizabeth R. Muratet, The Aftermath of Penn Square Bank: Protecting Loan Participants from Setoffs, 18 Tulsa L. J. 1982. P. 261-279.
- 4) McDermott Will & Emery: <https://www.mwe.com/insights/the-uk-court-of-appeal-rules-on-the-interpretation-of-frankenstein-contracts/>
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- 6) Re Woodson Co, Fireman's Fund Insurance v. Grover. 813 R zd 266 (9th Cir. 1987).
- 7) Trade Finance Global: <https://www.tradefinanceglobal.com/posts/yieldpoint-v-kimura-victory-for-market-practice-or-just-a-warning-on-how-to-draft/>
- 8) Yieldpoint Stable Value Fund, LP v Kimura Commodity Trade Finance Fund Ltd [2024] EWCA Civ 639.

Работа подготовлена с использованием системы КонсультантПлюс.