Bridge across the pond

What New York law participation agreements do and don't do when applied to English law loan transactions

The English insolvency proceedings of Lehman highlight many issues relevant to the rights of third parties in respect of their financial assets held by distressed UK financial institutions. Central among these issues is the ability to legally isolate those assets; in other words, structure transactions so that the assets will not be treated as part of the financial institution's estate during any English insolvency proceeding. In the context of loan sales, if a lender validly assigns its loan to a third party by way of sale on arm's length terms, that loan should be excluded from the lender's estate in any English insolvency proceedings. In some circumstances an assignment may not be feasible because, for example, of withholding tax or stamp tax issues, or restrictions in the loan agreement. Consequently purchasers of loans from UK financial institutions have examined alternative structures, including entering into New York law participation agreements in respect of English law loan agreements.

Against this backdrop, it's interesting to consider the issues in an English law insolvency proceeding relating to the determination of rights established by a New York law participation agreement, where the seller is an English incorporated company which has its centre of main interests in England. The treatment of these rights, including the ownership of the loan assets and the ability of the purchaser to convert the participation to a direct ownership interest, are of particular note.

The English situation

A market standard LMA [Loan Market Association] form English law participation agreement will not transfer to the purchaser any interest in the respective loan or payments under that loan. The purchaser receives only a contractual claim against the seller for amounts equal to the payments made by the borrower to the seller under that loan. The asset (the loan or rights in respect thereof) is not removed from the seller's estate, and the purchaser has no rights against the borrower. In the event of any insolvency proceeding against the seller in England, the purchaser would be treated as a general unsecured creditor of the seller with a claim *pari passu* with other unsecured claims. The payments under the respective loan by the borrower would be part of the seller's estate available generally to its creditors.

There are other structures under English law to insulate the purchaser of an interest in a loan in an English insolvency proceeding of the seller, or otherwise elevate the purchaser's status in any such insolvency proceeding, but each has attributes that limit its applicability. A trust created by the seller over the respective loan (as well as payments thereunder) provides the benefit that the transferred assets would be outside the seller's estate in an English insolvency proceeding, and would be available only for the beneficiary of that trust – the purchaser. This type of trust, however, has disadvantages. This structure may result in the purchaser being deemed the recipient of interest for withholding tax purposes and may trigger regulatory issues in some jurisdictions. Moreover, the loan agreement may contain restrictions or prohibitions on such trust arrangements. Finally, there is the mechanical problem that if the trust is administered by an insolvent entity, the trust agreement should have provisions to replace the trustee.

Alternatively, the English law participation structure could be retained. But to avoid the purchaser being an unsecured creditor and the loan being part of the seller's assets available to all creditors in an insolvency proceeding, the seller could grant to the purchaser a security interest over its rights to the loan, including payments thereunder, as well as over the account into which loan payments are made. This security interest would secure the seller's obligations to make the payments under the participation agreement. However there are often practical difficulties with segregating the loan and the flow of funds thereunder from other assets and receipts of the seller, so that specific security can be taken over the particular loan and the payments therefrom. In particular, if these proceeds are received into a general account with other payments, then the security interest taken will be at best a floating charge, assuming that the seller is prepared to accept a floating charge over the balance in the specified account from time to time. This has a lower priority than a fixed charge, and likely would not result in the underlying loan being removed from the seller's balance sheet. Additional issues include the right of the seller under the loan agreement to grant security in the loan, its ability to grant security on its assets generally and whether the security interest would affect the withholding tax analysis. Given these limitations with a traditional English law participation agreement, a trust structure and security interest, parties in the London loan participation market have sought other options.

The US situation

Historically the US courts, based on the specific language and the allocation of economic risks and benefits in the respective participation agreement, have construed the seller-purchaser relationship in a New York law-governed loan participation agreement in several ways. This includes as an assignment or sale, a trust or a loan. The analysis as to whether a transfer of property will be considered a true sale under US law will generally be determined in a bankruptcy court in case of non-bank sellers, and by the Federal Deposit Insurance Corporation (FDIC) receivership or conservator proceedings in the case of bank sellers. This is because the issue, for most purposes, only becomes relevant if the seller becomes subject to insolvency proceedings and the extent of the seller's estate must be established. Accordingly, many of the reported decisions originate in bankruptcy courts where the non-debtor purchaser will assert that its participation agreement effectively transfers the debtor-seller's interest in the respective asset to the purchaser, and therefore such asset is not part of the seller's estate. Under Supreme Court precedent – *Butner v United States* (1979) – in a US bankruptcy proceeding, state law, not federal law, governs the determination of a debtor's rights in assets. US banks (as well as foreign banks with a branch or agency in the US) are not eligible to be debtors under the US bankruptcy law (although bank holding companies are eligible). Accordingly, their insolvencies are handled under the banking law, and the case law from US bankruptcy courts on the property rights of a debtor is not direct precedent for the rights of an insolvent bank.

If drafted properly, a participation agreement under New York law results in the transfer by the seller to the purchaser of an undivided interest to the extent of the participation percentage in the future payments if made under the specified loan asset (*FDIC v Mademoiselle of California* (1967)). Several US non-bankruptcy courts (and bankruptcy courts handling the reorganisation of bank holding companies or non-bank financial institutions) have adopted a four-part test for determining the true nature of a participation agreement:

- the purchaser funds its purchase by payment to the seller,
- the purchaser's right to receive payment arises only when the seller is paid on the loan,
- only the seller has the right to bring claims against the borrower, and
- the participation agreement reflects the parties' intention that the participation agreement constitutes a 'sale' of an asset (namely, the payments to be made under the loan asset) by the seller to the purchaser (*Autostyle Plastics* (2001).

When a participation agreement reflects these provisions and includes customary sale and transfer language of an undivided interest in a specified percentage in the loan asset, US courts will not classify the transaction as a transfer of ownership in that loan asset, but rather as a transfer of an undivided interest to the extent of the participation percentage in the future payments if made under such loan asset (*FDIC v Mademoiselle of California*). The seller, under a New York law participation agreement that satisfies this four-part test, would be able to remove the loan from its balance sheet for US accounting and capital requirements.

The seller retains legal title to the loan asset with the purchaser acquiring an undivided interest to the extent of the participation percentage in the future loan payments if made. As such, the purchaser does not have any rights to enforce payment of the loan, including by bringing an action for non-payment or to vote on amendments (*Autostyles Plastics*). Nor can the purchaser set off the borrower's deposits with the purchaser against the loan (*Yale Express Systems* (1965)). But the purchaser will be treated as the owner, free from claims of the seller or its bankruptcy estate, of the purchaser's percentage in the payments if made by the borrower on the respective loan (*Re Drexel Burnham Lambert Group* (1990)).

If the seller is a US bank, or foreign bank with a branch or agency in the US, the rights of the purchaser are determined under the US banking laws – namely 12 United States Code §1821(e), and the related regulations under 12 Code of Federal Regulations §360.6 (2015) (Rule) promulgated by the FDIC. The key issue is whether, in the event the FDIC became the conservator or receiver of the seller, the FDIC could, by exercise of its authority to disaffirm or repudiate contracts, reclaim or recover the participation from the purchaser or recharacterise the participation as property of the seller or of the conservatorship or receivership for the estate of the seller. If the participation agreement provides for the 'sale' by the seller to the purchaser of an 'undivided interest and participation' to the extent of a specified percentage in the specified loan, such a participation agreement has been found to pass 'legal title' in such percentage of payments under or in respect of the loan to the purchaser (*FDIC v Mademoiselle of California*). This will be particularly true when the participation is: an undivided interest and participation in a specific payment stream; and without recourse to the seller of the participation. The Rule provides that:

'the FDIC shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts [under 12 USC § 1821(e)], reclaim, recover or recharacterize as property of the institution or the receivership any … transferred financial assets [in connection with participations]….'

Paragraph (a)(6) of the Rule defines a participation to mean 'the transfer or assignment of an undivided interest in all or part of a financial asset from … the 'lead', to … the 'participant,' without recourse to the lead….'. It further provides that the term 'without recourse' means that the participation is not subject to 'any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying obligation.'

However, a minority of courts have concluded that the purchaser is a lender to the seller with no legal or equitable interest in the loan. When a participation agreement is characterised as a loan, the agreement generally will include a guarantee of repayment by the seller and/or terms of participation which vary from the terms of the primary obligation, as to both duration and principal and/or interest. Where there is a trust, there should be specific language creating a trust relationship and empowering the seller to act as a trustee. Note that customary New York law participation agreements specifically provide that the seller is not a fiduciary and that no trust of any form is created thereunder.

Crossing the pond

Whether a New York law participation (which results, under New York law, in a true sale of payments under the loan) would be respected in an English insolvency proceeding of the seller has not been litigated. Moreover, there is no direct analogue in English law to the rights created by such a New York participation agreement. Therefore, any analysis first identifies the closest structure in English law to such participation agreement, and then determines the treatment of that structure. An initial component of that analysis is whether an English court would apply English law (given that the insolvency proceedings are in England) or New York law (the governing law of the participation agreement) in its determination as to the rights held by the purchaser under the participation agreement in the loan versus the seller's estate's rights therein. Without going into a complete conflicts of law analysis, it is likely that an English court would respect the parties' choice of New York law to determine the rights of each party under the participation agreement, but rely on English law to determine the treatment of such rights in the insolvency proceedings, based on English law precedent.

Pursuant to a properly drafted New York law participation agreement, the purchaser receives the beneficial interest in the

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purchased stream of payments under the loan but does not receive any interest in the underlying loan. Further, the purchaser will not have any rights against the underlying borrower of the loan and will not be entitled to take action against the borrower, even by joining the seller in any proceedings. New York law participation agreements also commonly include a provision that there is no intention to create a trust. On this basis, it is difficult to conclude that the participation agreement will create a trust over, or equitable assignment of, the rights of the seller under the loan. Although there is no precedent in English insolvency proceedings, the closest English law structure to the New York law participation would be a receipts trust pursuant to which the payments under the loan would not be part of the seller's estate. A receipts trust would be a trust created by the seller over its actual receipts under the loan, but not over its right to receive payments. One obvious concern is whether the English court would feel compelled to reject the receipts trust analogy because the New York participation agreement specifically disclaims any intention to be or create a trust. While that reaction cannot be discounted, it would be surprising for an English court to conclude that the New York participation agreement gave rise to no proprietary interest at all, given the clear position under New York law and the intention of the parties (by their choice of New York law) to create such an interest. More significant proprietary interests appear more challenging given the terms of the participation agreement.

There are clearly disadvantages to a receipts trust by comparison to an equitable assignment, or a trust created over all the seller's rights in its relevant portion of the underlying loan. The purchaser would have no rights against the underlying borrower, and to the extent it wished to control the actions of the seller in dealing with the rights in the underlying loan, it would need to rely on contractual restraints included in the participation agreement rather than any proprietary interest. Further, the receipts trust would depend upon the segregation and identification of the relevant receipts; if there was co-mingling of the receipts with other payments the trust could be defeated. It is therefore not surprising that, as with the market standard LMA form, most New York law participation agreements give the purchaser the right to request the seller convert the loan participation into a direct assignment of the relevant portion of the loan to the purchaser, with the seller agreeing to take all actions required to effect that assignment under the respective loan agreement (assuming such assignment is permitted thereunder). Although practically the purchaser should know of the seller's financial distress well before any insolvency proceeding, and therefore exercise its conversion rights at that time if it deems appropriate, it is possible that the purchaser may seek to convert the participation during an insolvency proceeding.

The analysis of the relationship of a purchaser with a financial institution seller would be incomplete without consideration of the relevant resolution framework applicable under English law to the financial institution and particularly the statutory termination and bail-in possibilities. However, both this and the operation of elevation rights in a financial institution insolvency proceeding, merit a an anlaysis all of their own.

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