VINOD KOTHARI CONSULTANTS
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The Law of Co-lending

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Contents

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Law of co-lending

Two or more entities joining together for creating an asset, having a liability, carrying an operating activity, or doing a venture, whether for a limited period or purpose, or for longer period, indefinite period, etc., have existed for times immemorial. In the context of lending, there may be two or more (in the rest of this work, the expression two may, where befitting in context, include more than two as well) lenders joining together for a loan, or two borrowers joining together for a borrowing.

The motivations for lenders to join as co-lenders may be numerous - either because of the size of the loan, exposure restrictions, risk management, differential origination capabilities, differential level of franchise with the borrower base, etc.

The motivations for borrowers joining together for a borrowing may, likewise, be numerous - spreading or supporting of the liability, utilisation of the loan by the joint borrowers depending on need at different points of time, etc.

In case of joint borrowing (also called co-obligation, co-borrowing, co-obligors, co-lendees, etc), it is always a question as to whether the so-called co-obligor is merely a guarantor, and is joining merely for the purpose of supporting the credit of the principal borrower, who is actually utilising the loan. In case of co-lending too, there are often questions as to whether the funding co-lender (referring to the co-lender who is not involved in origination and servicing of the loan) is merely taking exposure on the originating co-lender, or both of them are actually taking exposure on the borrowing.

RBI introduced guidelines for co-origination of loans by Banks and NBFCs for lending to the priority sector in September, 2018[1]. Subsequently, in November, 2020, RBI issued a revised set of guidelines for co-lending by banks and NBFCs to the priority sector[2]. These guidelines recognised the concept of 'co-lending' in India, though co-lending arrangements between financial entities have been in existence even before the regulations were issued. While the guidelines are restricted to co-lending by financial institutions to the priority sector, co-lending is a wider concept and is used outside of the priority sector context as well. There is a strong feeling that co-lending is being widely used as the device of bridging the origination and funding of retail loans by two entities, and essentially a reflection of entities trying to make use of their differentiated origination and servicing capabilities.

In the global context, the nomenclature may be different. There are similar connotations in the credit market - to name a few, syndicated lending, loan participations, consortium financing, etc. Participations may result into sale of participation notes, *pari passu* notes, etc. Irrespective of whether these concepts are fundamentally different, they seem to be contextually different. While in economic sense, it would be easy to say that, in each of these scenarios, there are multiple lenders against one borrower (or joint-borrowers, as the case may be); however, it would be interesting to understand whether these create similar or different lender-borrower and lender-lender relationships; and whether the usage and economic effect of each of these transactions remain the same.

[1] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11376&Mode=0
[2] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11991&Mode=0

This article delves into the fundamental concept of co-lending, its usage in various contexts such as syndicated lending, loan participations, etc. Our write-up is an attempt to develop the law on co-lending, as all that practitioners currently have is the regulatory piece in the form of the CLM framework for PSL loans.

Legal nature of co-lending

Co-lending has been explained as a horizontal network of lenders. Two or more lenders come together to advance a loan. Normally, the due diligence will have been exercised by both the co-lenders. It is a horizontal network to the extent the co-lenders take part in the process of loan origination. If one lender originates a loan, and subsequently gets other participants to participate in it, as would be the case of loan participations, it becomes a vertical network.

An article[3] discusses the legal nature of co-lending as an arrangement where "there is often an originating or agent lender, the co-lenders are usually direct parties to the credit agreement to the borrower. The relative rights and obligations of the co-lenders amongst themselves are governed by specific provisions in the credit agreement or in a separate co-lender agreement."

Rights of co-lenders, co-mortgagees and 'singleness' of debt

In the essence of co-lending, it is a contract between typically two parties to lend to a borrower. Both lenders decide and agree to lend to the ultimate borrower together, in accordance with the co-lending agreement executed between both lenders. The relationship between both the lenders is defined by a 'contract' between them (inter-creditor or co-lender agreement). While the relationship between the co-lenders and the borrower is defined by a 'loan agreement' between them.

The legal nature of the relationship between the co-lenders is defined by contract law. In India, the Indian Contract Act, 1872 ['Contract Act'] deals with joint rights under section 45[4] of the Contract Act. In case two parties lend to a borrower, the borrower is liable to both of them jointly, resulting in a case of liability to 'joint promisees' under the Contract Act.

In the matter of *Govindlal Bhikulal Maheshwari vs Firm Thakurdas Bhallabhadas and ors. (1973)*[5], the Hon'ble Bombay High Court explained that section 45 of the Contract Act has two parts. The first specifies with whom the right to claim performance rests, in the case of joint promisees. The court held that "unless a contrary intention appears from the contract, the right to claim performance rests, as between the promisor and the joint promisees, *with the joint promisees during their joint lives."* The second part specifies with whom the right to claim performance rests in case

[3] Christopher B. Price and Lauren T. Lebioda (2009), "Lender Defaults: The New Reality Facing Real Estate Debt Investors" - https://www.goodwinlaw.com/-/media/files/publications/attorney-articles/2009/price-lebioda-the-journal-of-stuctured-finance.pdf

[4] Section 45 of the Contract Act states that "When a person has made a promise to two or more persons jointly, then, unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and, after the death of any of them, with the representative of such deceased person jointly with the survivor or survivors, and, after the death of the last survivor, with the representatives of all jointly."

[5] https://indiankanoon.org/doc/333050/

of death of any of the joint promisees. Given the joint nature of the right, it has been the settled position of law that performance of the promise, in the instant case the loan, can be demanded and enforced by the two parties jointly, unless the two of them have nominated one of them, or a third party, to exercise the joint right as an agent.

Since creation of mortgage rights in favour of joint mortgagees has been a common phenomenon, there are several judicial precedents upholding indivisibility of mortgages, and singleness of debt.

In Adiveppa Channappa Kittur vs Rachappa Balappa Hosmane (1946)[6], Bombay High Court said "A mortgage is a contract, whereby the mortgagors usually, and as in this case, agree to repay a single total sum to the lender or lenders, and in default to have the single total sum raised by the sale of the security. It is not the contractual bargain that if the mortgagee's title should devolve on several co-owners, that each co-owner should have the right to demand piecemeal a proportionate sum and have such proportionate sums raised by the sale of the whole or some part of security. Such an arrangement could only arise from an express agreement with the mortgagors."

The rights of a co-mortgagee was also laid down by the Bombay High Court in the case *supra* by stating that in the case of co-mortgagees "a single co-mortgagee cannot sue to recover the entire mortgage amount on his own behalf; nor can he sue to recover his own share of the mortgage amount, as the mortgage is indivisible. *He must bring a suit to recover the entire amount on behalf of himself and the other co-mortgagees.*"

Referring to the ruling in *Huthasanan Nambudri v. Parameswaran Nambudri (1898)*[7], *Mohammed Ismail Maracair v. Doraisami Mudaliar*, reported in AIR 1958 Mad 621[8], Madras High Court made the following important remarks -
"It is well settled that a mortgage is one and indivisible in regard to the amount and security.

> " . . a mortgage for an entire sum is from its very purpose indivisible; a division of such a mortgage, borrowing the language of a text writer, is conceivable in theory and may be carried out in practice. But in order that a mortgage may fully attain its end of securing satisfaction of the entire obligation in the rank and with the efficacy which the law or the will of the parties determined, it is essential that it should not suffer any disintegration.
> "This character of indivisibility exists not only with reference to the mortgagee, who may generally be more benefited thereby, but also with reference to the mortgagor. And save as a matter of special arrangement and bargain entered into between of all the persons interested, neither the mortgagor nor the mortgagee, nor persons acquiring through either a partial interest in the subject, can, under the mortgage, get relief except in consonance with the principle of indivisibility referred to."
> "It is not open to some of the mortgagees to split up the debt without the concurrence of the other mortgagees and the mortgagor."

In Peer Ammal v. Nalluswami Pillai (1937)[9], it was observed, "if it becomes necessary to sell the whole or anything in excess of a proportionate part of the hypotheca to realise even the amount due to the plaintiff-co-mortgagee, it will be neither fair nor consistent with the policy of the law to allow the plaintiff to appropriate the proceeds wholly in satisfaction of his claim. Justice can be done between all the parties concerned only by providing in the decree for the distribution of the sale proceeds amongst the co-mortgagees."

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[6] https://indiankanoon.org/doc/546781/?type=print
[7] I.L.R. 22 Mad. 209 at 211
[8] https://indiankanoon.org/doc/1222587/
[9] 2 M.L.J. 666 - https://indiankanoon.org/doc/575502/

Thus, as remarked in *Sunitibala Debi v. Dhara Sundari Debi Chowdhurani (1919)*[10], it was a case of a single mortgage executed in respect of the same property to secure two sums of money respectively payable to two mortgagees. The Privy Council held that the mortgage clearly effected a conveyance of the real estate to the mortgagees as tenants is common and that *it was not a mortgage to each of a divided half but a conveyance to them of the whole property*.

In Maharashtra State Financial ... vs Ballarpur Industries Limited[11], Bombay High Court held that:

> *" . . .one co-mortgagee cannot sell or institute any proceeding for the sale of the mortgaged property without joining the other co-mortgagees. If the other co-mortgagees are not willing to join as plaintiffs, they should be joined as defendants. This is because the mortgaged security is one and it must be realised as a whole by a common sale."*
>
> *Accordingly, co-lending would be a case of joint promisees, where the lenders jointly agree to lend to a borrower who is liable to both the lenders collectively under the loan agreement. The co-lenders have a joint right/claim over the debt owed by the borrower which stems right from the inception of the contract.*

Co-lending is essentially akin to a joint ownership of the loan asset by and between the co-lenders; it is akin to a special purpose partnership, barring the principal-agent relationship essential to the concept of partnership.

Can a loan asset be joint and several?

In general, as a basic common law principle, liabilities may be joint and several, but assets may be either joint, or several - they cannot be joint and several. An asset co-owned by parties results in creation of a joint right that is indivisible and must be enforced either 'jointly **or** severally', not 'jointly **and** severally'. Essentially, the asset cannot be split up as the claim devolves on the owners jointly, as discussed elaborately above.

In P. Govinda Reddy And Ors. v. Golla Obulamma (1970)[12], AP High Court while talking about section 45 of the Contract Act, held that "That provision is explicitly clear that joint promises cannot divide the debt and sue severely for their respective portions unless a contrary intention appears from the contract. What is true in the case of joint promises equally applies to their representatives on their death. Section 67 of the Transfer of Property Act inter alia embodies similar principle as contained in Section 45 of the Indian Contract Act. No suit, therefore, can be brought to enforce a mortgage which would involve splitting up of either the amount or security unless there is a contract to the contrary."

There are several rulings, as discussed above, that state that in case of a joint claim on an asset (or a case of joint promisees under section 45 of the Contract Act), the joint owners cannot sue separately and must sue jointly.

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[10] (1920) 22 BOMLR 1 - https://indiankanoon.org/doc/1482364/

[11] AIR 1993 Bom 392 - https://indiankanoon.org/doc/1732313/

[12] AIR 1971 AP 363 - https://indiankanoon.org/doc/539417/

Co-lending: The scenario in India

Co-lending for priority sector loans:

In India, banks have certain targets with respect to lending to the 'priority sector' imposed by RBI and hence, in order to help banks achieve these targets, the CLM framework was introduced, which helps leverage the comparative advantages of banks and NBFCs while lending to the priority sector. Thus, the CLM guidelines were introduced for co-lending of loans that qualify for the purpose of 'priority sector lending' ('PSL').

The CLM regulations require the banks and NBFCs entering into a co-lending arrangement to have a 'Master Agreement' for the purpose of implementing the CLM. The said agreement must provide for the bank to either take its share of the loans originated by the NBFC on its books or retain discretion to reject certain loans subject to due diligence.

In case discretion is exercised by the bank with respect to the loans it takes on its books (so-called 'cherry picking' of loans or 'discretionary co-lending'), the same will be akin to a direct assignment transaction. In this case, the bank taking over the loans on a discretionary basis would have to comply with all the requirements of the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021[13] ('TLE Directions') with the exception of the Minimum Holding Period ('MHP') requirements.

The intent of permitting discretionary co-lending in the PSL CLM framework is to promote PSL loans and ultimately reduce the interest rate for the borrower, through the blended rate of interest. Thus, discretionary co-lending is an exception under the CLM framework[14].

Co-lending for non-priority sector loans

The intent of the CLM was to enable priority sector treatment in case of banks partnering with NBFCs. However, there does not seem to be a reason to contend that co-lending is not possible outside of the priority sector. Co-lending is a simple case of two lenders joining together for extending a loan, as has been done, over the years, in case of corporate loan exposures under consortium lending approach. Without doubt, each of the lenders do their own due diligence, both for credit and KYC purposes. They may have a mutual co-lenders' agreement, in addition to an agreement with the borrowers (which may, understandably, be a common agreement). They may agree on a blended interest rate, and put all loan repayments into a common account from where the two co-lenders may split the repayments to their separate bank accounts. One of them may act as the servicer, for the purpose of maintaining interface with the borrowers, and failing such an arrangement, both of them will have a privity with the customer.

Thus, while RBI's CLM framework has been issued in a limited context and for a specific purpose, one may generalize co-lending in India as follows:

[13] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/86MDLOANEXPOSURESC6B1DFB428C349D885619396317F04DE.PDF

[14] See our earlier article on CLM framework issued by RBI here: https://vinodkothari.com/2020/11/new-model-of-co-lending-in-financial-sector-scope-expanded-risk-participation-contractual-borders-with-direct-assignment-drawn/

Particulars	Discussion
Number of co-lenders	Two, but there may be more than two as well. However, the practice should not be one of selling participations to several investors, as that may amount to formation of a collective investment vehicle.
Nature of co-lenders	Financial sector entities, engaged in the business of giving loans
Type of loans	Priority sector or non-priority sector loans
Minimum share of each co-lender	In the case of the CLM framework, there is a minimum 20% retention by the originating co-lender. While there is no regulatory stipulation in this regard, but in order to ensure skin-in-the-game of the originating co-lender, the latter should continue to have a minimum participation, say, 20%. If the originating co-lender retains an insignificant share, it will be cutting against the principle of risk-retention, and may be taken at par with a transfer of loan exposures.
Sharing of risks and rewards	In view of the differential role of the different co-lenders in the arrangement, the rates of return in the loan(s) may be shared differently by the co-lenders. However, see comments below on one co-lender giving assurance to other co-lenders
Is the originating or servicing co-lender providing any services to the arrangement	This question may arise primarily from GST or taxation viewpoint - can it be argued that the co-lender who is retaining higher interest is actually providing services to the arrangement, and therefore, should be paying GST on the services to the consortium? In this case, the arrangement is not in the nature of a joint venture, with the venture being a separate entity. It is simply a case of differential services performed by each of the co-lenders, and hence, the question of any services provided by one to the arrangement does not arise.
Interest Rate	an all-inclusive rate is communicated to the borrower that is mutually agreed by the co-lenders

Co-lending versus transfer of loan exposures

In case of co-lending, there is a retention of a share by the originating co-lender, and in most cases, the financing co-lender takes a larger share. In case of transfer of loan exposures (TLE), there may be retention of a share, of course on a *pari passu* basis, by the originator. Thus, there is a strong likelihood of a co-lending having substantial similarity with TLE. We need, however, to note the differences between the two:

Particulars	Transfer of loan exposures	Co-lending
Use as a mode of transfer/acquisition of loan exposures	Acquisition of a single loan or pool of loans, on bilateral basis	No transfer or pooling. Loans are originated by co-lenders pursuant to an arrangement between them- either discretionary or non-discretionary
Intent of the buyer	Should be typically expansion of loan book	NA – There is no buyer (there are co-lenders intending to build their books)
Intent of the seller	Liquidation of loan/loan book, reduction of concentration, etc	NA – There is no seller (there are co-lenders)
Ease of execution	High - loans are shifted from lender's book to acquirer's books.	High - Loans are co-originated by co-lenders and the customer facing is being done by any one of the lenders
Legal method of "transfer"	Assignment, novation or participation	NA – does not involve transfer
Bankruptcy remoteness	Yes	NA – co-lenders recognise the loan to the extent of their respective exposure
Continuation of originator as servicer	Possible	Normally, one of the co-lenders acts as servicer
Credit enhancement by originator	Not possible	Refer our discussion under the head, "Credit enhancement by the originating co-lender"
Lender on record	Assignor	Each co-lenders for its loan share. For PSL loans, NBFC has to be the 'single point of interface'. For non-PSL, it would depend upon mutual agreement between co-lenders. Irrespective of who the point of contact is, both lenders would remain on record.
MHP requirements	Applicable	NA
MRR requirements	Not applicable where buyer does full DD, else 10%.	In case of PSL loans - if the originating co-lender is an NBFC, minimum risk retention of 20%.

Capital relief	Transferred loan/loan share reduces from assets; proportional capital relief.	None – loan is still on the books. However, the capital will have to be maintained only on the lender's exposure, and need not been on the entire loan.
Cherry picking of loans	Possible	Possible in case of discretionary co-lending permitted under the CLM regulations as an exception to promote PSL loans. Not possible in other cases.

Discretionary and non-discretionary co-lending

The so-called discretionary co-lending amounts to cherry picking of the loans by the financing co-lender after the loans have already been originated. If the loan has been originated, the case is one of assignment of an existing loan relationship. Therefore, except where the arrangement falls under the CLM framework for PSLs, it should be clear that assignment of an existing loan to a participating co-lender amounts to a transfer of a loan exposure, and not co-lending.

The intent of allowing cherry-picking of loans by the financing lender is to allow it a reasonable amount of time to carry out due diligence of the loans, before taking them on their balance sheet, and eventually to provide the benefit of lower interest rates to the PSL borrowers - as the financing lender would be able to choose assets with preferred risk features and it is likely that the borrower would be charged overall a lower rate of interest due to the blended rate of interest.

In fact, the CLM for PSLs also says (discussed earlier as well) that if a bank can exercise its discretion regarding taking into its books the loans originated by the NBFC as per the Agreement, the arrangement is akin to a transfer of a loan exposure. Accordingly, all the requirements of the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 shall apply, with the exception that the Minimum Holding Period ('MHP') requirements shall not apply for transactions undertaken in terms of the CLM regulations. Therefore, the exception for MHP is given as a carve-out.

As regards the discretionary co-lending for PSL loans, the following points may be noted:

While the discretionary co-lending framework permits the co-lender to come after the loan has been originated, the question is - how much time may elapse between the origination of the loan and the acquisition of the share by the financing co-lender? Can the financing co-lender, for example, come after 3 months of origination, and still call it a case of co-lent loan? As we have discussed earlier, the intent of permitting co-lending on a cherry-picking basis was specifically to provide the benefit of lower interest rates to the borrower in case of PSL loans. If the loan has already been running, it is unlikely that the borrower will get the benefit of reduced interest rates due to participation of the co-lender. Hence, in our view:

(a) **The participation of the co-lender, though on a cherry picked basis, should be soon after origination for the loan, say, before the first of the instalments falls due.**

(b) The intent of the so-called discretionary co-lending is not to develop a track record of performance of the borrower, and then bring the financing co-lender as a co-lender. If MHP or nearabout has already been achieved, then there is no need to fall back on the CLM, as the TLE Directions may easily cover such a situation.
(c) The idea is to not leave CLM to give a profit to the originating co-lender, but to result into a benefit to the customer. Therefore, the entry of the co-lender, even though after origination of the loan, should result into a benefit to the borrower, maybe in form of a rebate or lower interest rate.

Credit enhancement by the originating co-lender

The relationship between the co-lenders in a co-lending arrangement is similar to that of a 'special purpose partnership' with the exception of the principal-agent relations. Accordingly, in line with the principles of partnership, the co-lenders are partners in profits, and in losses. As in case of partnerships, the capital contribution ratio, profit sharing ratio and loss sharing ratios may all be different. Besides, different partners may have different roles in the arrangement. However, is it possible for the originating co-lender to secure the returns of the financing co-lender?

In any arrangement, the substance of the arrangement is what determines its name, and not its nomenclature. The substance of co-lending is that both the co-lenders are exposed to the underlying pool. They take risks and rewards in the pool, and not in one of the partners.

On the other hand, the idea of one co-lender guaranteeing or securing the returns of the other co-lender seems counterintuitive to the principles of partnership. If, for instance, the originating co-lender (a) retains a small portion of the risk sharing arrangement; (b) provides a guarantee to the funding co-lender protecting the funder from losses; and (c) also sweeps the actual rate of return from the collateral pool over and above the fixed rate of return that goes to the funder, the arrangement partakes the character of a loan from the funder to the originator.

A so-called non-discretionary co-lending, where the funding co-lender relies on the credit due diligence done by the originating co-lender, would substantively look like a funding facility to the originating co-lender, if the funding partner is entitled to a fixed rate of return from the collateral pool. On the other hand, a discretionary co-lending, where the funding co-lender enters the loan after the same has been originated, takes the character of an assignment of a loan, and is, therefore, covered by the TLE Directions, which prohibits any form of credit enhancement by the originator.

Thus, in our view, provision of credit enhancement by the originating co-lender seems to be cutting against the principles of co-lending. Differential sharing of risks and rewards is possible, but a structure insulating the funder from risks, and depriving of rewards over a pre-fixed rate, seems unsustainable with the nature of co-lending.

Syndicated lending

What is syndicated lending? Structure, *modus operandi*, phases, etc.

According to a report by Refinitiv[15] "Global syndicated lending totaled US$3.5 trillion during full year 2020, a 24% decline in total proceeds compared to full year 2019, and the slowest annual period for lending since 2012." Another report[16] cites that the global syndicated lending market has become highly globalized, with the amount of globally syndicated loans rising from $800 billion in the 1990s to over $2 trillion in recent years. MUFG Bank (one of Japan's largest banks) cites[17] that "Since 2009, global syndicated loan volume rapidly increased by 253% to US$4,710 billion in 2017."

Syndicated lending in practice has resulted into significant secondary market activity in participations. "Certainly, recent changes in the syndicated loan market – including its volume, its capacity to provide sizable medium and long-term funding and increased transparency – have shifted the syndicated loan market closer to the corporate bond market and further away from bilateral bank lending."[18] So much so that in the USA, there has been litigation on whether loan participations via the syndicated lending route constitute "securities" (discussed later in detail).

Syndicated lending essentially involves multiple lenders (thereby forming a syndicate) extending credit to a single borrower, whose needs may not be fulfilled by a single lender. It involves a syndicate of lenders that are put together by a lead banker/manager. Each lender is directly involved in a lending relationship with the ultimate borrower, i.e., they each provide financing to the borrower.

A report by Denis Petkovic[19] explains the syndication process in two phases. The first phase of the syndication process is the pre-mandate phase which involves discussions with the borrower and the potential arrangers/ lead managers about the proposed facility to be extended to the borrower.

The post-mandate phase involves putting together the syndicate of lenders, negotiation of facility agreements and essentially, syndication of the loan. There are some concerns over the lead managers role, because during the pre-mandate phase, the lead manager almost acts as an agent of the borrower, but during the post mandate phase the lead manager acts on behalf of both the syndicate and the borrower leading to potential conflicts of interest.

Role/ duties of the arranger

The arranger may have several reasons for arranging a syndication. The motivations for the arranger include a means of avoiding excessive single name exposure or a means to earn fees and diversify income, meeting borrowers demands for loan commitments without having to bear the market and credit risk alone, etc.[20]

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[15] Report by Refinitiv: Global Syndicated Loans Review: Full Year 2020 | Managing Underwriters

[16] Janet Gao, Yeejin Jang, 2018. "What Drives Global Syndication of Bank Loans? Effects of Capital Regulation" - http://apjfs.org/resource/global/cafm/2018-4-1.pdf

[17] https://www.bk.mufg.jp/global/productsandservices/corpandinvest/syndication.html

[18] https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1028.pdf

[19] Arranger Liability in the Euro Markets - https://www.pillsburylaw.com/images/content/2/3/v2/2392/97BB1EC9C027B682FD0FC7053C115B98.pdf

[20] Source: The syndicated loan market: structure, development and implications - https://www.bis.org/publ/qtrpdf/r_qt0412g.pdf

In a consortium or syndicated lending, one of the lenders assumes the role of a leader, and hence, the question is whether such leader is responsible in fiduciary capacity to the other members of the consortium. On this issue, there are several UK rulings:

On potential fiduciary duties of the consortium majority in the case of *Redwood Master Fund, Ltd and Others v TD Bank Europe Limited and Others*[21], it was held that, in case of a syndicate arrangement, as long as decision taken against the minority is not done with an intent to give undue gains to the majority, or damage the interest of the minority, the decision taken shall be valid.

On duties of the arrangers towards other consortium members, in *Raiffeisen Zentralbank Österreich AG v Royal Bank of Scotland plc*, the syndicate banks contended that it had been induced to enter the contract with the defendant (the arranger) by several material misrepresentations. The England and Wales High Court held that there was no misrepresentation on part of the arranger. Further, in the case of *Sumitomo Bank Ltd v Banque Bruxelles Lambert SA*[22], the High Court of England and Wales held that the arranger owed a duty of care towards the participant banks.

The English Court of Appeal in *UBAF Ltd. v European American Banking Corporation*[23], held that in a syndicate arrangement, wherein the arranger invites other parties to participate in the grant of loan, the arranger acts in a fiduciary capacity. Accordingly, the arranger has the duty to inform the participating banks of any material events during the contract.

In *IFE Fund SA v Goldman Sachs International*[24] ('IFE Fund case'), the English High Court and the English Court of Appeal held that the participants in a syndication will be bound by documents that they enter into and that disclaimers from liability will normally be effective in negating any duty of care of an arranger. Where an arranger has "actual knowledge" that the information it holds renders an information memorandum previously circulated materially incorrect, it will be bound to make disclosure but not otherwise[25].

The *IFE Fund case* is a landmark judgment in the syndicated lending industry for arrangers. It essentially provides that arrangers must be looked at as an agent of the borrower or as independent contractors.

On fiduciary duties of the agent, the Privy Council in case of *Kelly v Cooper*[26], stated that an agent can act for more than one principal at the same time and the agent is not liable to disclose confidential information of one principal to the other principal.

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[21] [2002] EWHC 2703
[22] [1997] 1 Lloyd's Rep 487
[23] [1984] Q.B. 713
[24] [2006] EWHC 2887
[25] Source: https://www.pillsburylaw.com/images/content/2/3/v2/2392/97BB1EC9C027B682FD0FC7053C115B98.pdf
[26] [1992] 3 W.L.R. 936

What is the connection between syndicated lending, and leveraged loan?

Leveraged loan is a term used mostly to describe a below-investment grade loan[27]. Since these loans, if involving substantial amount, are typically shared by several lenders, arranged by the arranger, it is "syndicated", and hence, leveraged loans are mostly funded by syndicate of lenders or loan participations. The relationship between leveraged loans and syndicated lending is incidental, rather than fundamental.

Loan participations

Is loan participation the same as co-lending?

Loan participation is quite a common practice in the banking world. In India, inter-bank participation certificates may also be viewed as a form of loan participation. The TLE Directions also allow transfer of participatory rights in a loan, after its origination, with or without the transferring the legal title. A loan participation involves a lead underwriter or syndicate leader, who underwrites the loan and subsequently sells participation rights to various other lenders, called participants.

The Office of the Comptroller of the Currency (OCC), an independent bureau of the US Department of Treasury, states[28] "A loan participation is a sharing or selling of interests in a loan. xx.. Banks may sell participations to enhance their liquidity, interest rate risk management, and capital and earnings. They may also sell participations to diversify their loan portfolio and serve the credit needs of borrowers."

Under loan participation, the general structure essentially involves the 'originating lender' or 'lead bank' that originates the loan. Post origination of the loan, the originating lender sells or transfers a portion or percentage of this loan to another financial institution, called the 'participant'. The relationship between the originating lender and the participant is then governed by a participation agreement.[29]

Issuance of participation rights by the originating lender is a mode of transfer of the loan - whether fully or partially - intended to be transferred. This matter is now settled by a Privy Council ruling in *Lloyds TSB Bank PLC vs. Clarke & Anor* (Bahamas) (2002)[30].

Unlike in case of loan participation, in co-lending, presumably, both the lenders have exercised their own due diligence

[27] https://www.spglobal.com/marketintelligence/en/pages/toc-primer/lcd-primer#sec1

[28] Source: https://www.occ.treas.gov/topics/supervision-and-examination/credit/commercial-credit/loan-sales.html

[29] Source: Kevin B. Fisher, 1990. *"Loan Participations and Bank Failures: The Penn Square Decisions"* - https://scholar.smu.edu/cgi/viewcontent.cgi?article=2824&context=smulr

[30] https://www.casemine.com/judgement/in/5779fbfce561096c93131997

and therefore, neither co-lender can be presumptively put under fiduciary responsibilities. However, the question would mostly hinge on the facts - whether the information about the borrower was collected and shared by one of the co-lenders, or both the co-lenders had a relationship with the borrower.

It is not uncommon for the individual lenders in a co-lending arrangement to have had previous dealings with the borrower as opposed to a loan participation arrangement wherein, typically the lead lender has had frequent dealings with the borrower, while the participating lenders may not have had frequent or any dealings with the borrower in the past[31].

A loan participation is regarded as a sale of the originating lender's interest; co-lending, on the other hand, usually implies the origination of the loan by the co-lenders from the very inception of the loan.

In case of a participated lending, there is an arranger who is mandated by the borrower to form a syndicate of lenders and organise the funding. The arranger is typically the lead of the consortium and also normally has a major share in the loan. The rest of the syndicate members normally do not have a relationship with the borrower.

In case of co-lending, on the other hand, while there is an originating lender, it is not uncommon for each of the lenders to have ongoing relationships with the borrower, before and after the jointly originated loan.

Asian Development Bank (ADB)[32], for example, distinguishes between a so-called complementary financing structure and a parallel loan structure - the latter is described as a co-lending arrangement. The complementary financing scheme of ADB for instance, is essentially a loan participation scheme where ADB acts as the lender on record while the other lenders participate in the transaction by entering into a participation agreement. Under the parallel loans structure, all co-lenders sign a common terms agreement, essentially entering into a co-lending agreement.

Loan participations typically have several participants; co-lending is typically between two entities only.

The legal distinction between co-lending and loan participations will actually be supported or contradicted by the actual matrix of facts. If the funding co-lender has actually relied upon the origination and credit underwriting by the originating co-lender, then the fiduciary responsibilities attracted to lead arranger in syndicated lending apply in case of co-lending too. However, if in co-lending, each of the co-lenders have done their own due diligence, and have their own relationship with the borrower, the originating co-lender cannot be construed as agent of the other lenders.

An article[33] brings out the difference between loan participations and co-lending agreements by stating that "In the case of participation interests, the seller is often the originator of the underlying loan, who retains a senior interest and the role of "agent" or "lead lender" and is typically the only party with direct contractual privity with, and primary

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[31] Source: Lester M. Bliwise, Norman W. Gutmacher and Edward A. Peterson (1997). "The Relationship amongst Co-Lenders -Identifying the Different Policies and Approaches of Co-Lenders Before a Deal Goes Bad" - https://cdn.ymaws.com/www.acrel.org/resource/collection/C4C61E50-CC2D-42D6-B133-18B2AA2AB2FF/1997BliwiseGutmacherPeterson_(spring).pdf

[32] https://www.adb.org/what-we-do/private-sector-financing/loan-syndications

[33] https://www.goodwinlaw.com/-/media/files/publications/attorney-articles/2009/price-lebioda-the-journal-of-stuctured-finance.pdf

obligations to, the borrower. Participants acquire individual interests that are fully derivative of the originating lender's interest and that are governed by a participation agreement."

While in the case of co-lending, the co-lenders are direct parties to the agreement with the borrower, *albeit* there can be only one co-lender acting as a single point of contact for the borrowers.

Transferability of Loan Participations

Loan participations may be transferable further. Co-lending is a sort of partnership between the co-lenders and therefore not transferable by the co-lender without the concurrence of the other co-lender.

One of the questions of significance was whether loan participation agreements are "securities" or "notes" (which are also securities). In identifying whether loan participations constitute "notes" the Supreme Court in the US set forth a "family resemblance" test in the case of Reves v. Ernst & Young[1]. Under this test, a note is presumed to be a security, unless upon examination of the note based on four factors (listed below) would reveal a strong resemblance between the note and one of a list of instruments that are not securities[2].

The four factors set forth under the "family resemblance" test[3] are as follows -

- the motivations that would prompt a reasonable buyer and seller to enter into the transaction - the relevant question here is whether the overall motivation of the parties is for commercial purposes or investment purposes? If the instrument is issued to facilitate the purchase and sale of consumer goods (or to advance any other consumer purpose), the "security" designation is less appropriate.
- the plan of distribution of the instrument - the relevant question here would be whether the distribution is made to a broad segment of the public? If yes, it may connote an instrument in which there is "common trading for speculation or investment".
- the reasonable expectations of the investing public - The public perception of an instrument as a security may weigh in favour that the instrument is a security, and;
- whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary.

In a leading case on whether loan participations qualify as "notes" for the purpose of identifying whether they are securities, the United States Court of Appeals, Second Circuit, held in Banco Espanol de Credito v. Security Pacific National Bank[4] that loan participations are not "notes" and thus, not securities. This was ruled after applying the "family resemblance" test.

The Loan Syndications and Trading Association ('LSTA') has also intervened on the matter and submitted an amicus brief[5] to a federal district court in New York, that loan participations, as well as, syndicated term loans are not securities. The implications of ruling that syndicated term loans are securities would be adverse to the present industry practices. The syndication would be more cumbersome and the details in the information memorandum would also undergo substantial change. Further, the time taken in the process would increase and thus, access to funds may be slower.

In an August 2023 ruling in the matter of Kischner vs J P Morgan Chase [https://law.justia.com/cases/federal/appellate-courts/ca2/21-2726/21-2726-2023-08-24.html] , the US Second Circuit Court of Appeal held that participation notes are not securities, applying the test discussed above.

Is syndicated lending distinct from loan participations?

J. Thomas Cookson (1983)[34] provides a clear distinction between 'loan participations' and 'loan syndications' by stating that "A loan participation is similar to a loan syndication in that a group of banks provides funds to a borrower. In a loan syndication, however, each bank signs the loan agreement with the borrower and receives a note representing its share of the indebtedness, and thus has a separate and distinct legal relationship with the borrower. Conversely, in a loan participation, the lead bank alone deals directly with the borrower and retains all loan documentation, including the borrower's note representing the amount borrowed. The participating banks are involved solely with the lead bank and have no rights directly against the borrower."

"A syndicated loan is granted by a group of financial institutions (the "syndicate") to a single borrower. The lending syndicate includes at least one lead institution (the "lead arranger(s)", sometimes called "underwriter(s)") as well as one or more participants. Lead arrangers negotiate preliminary loan terms and conditions and, upon agreement with the borrower, put together the group of participants to fund parts of the total loan amount. In return, lead arrangers receive an arrangement fee."[35]

From the above, it is clear that in the case of loan participation, the originating lender makes a loan to the borrower and subsequently sells participation rights to other lenders. The other lenders to whom the participation rights have been transferred would likely not have had any prior interaction with the borrower.

Whereas in a loan syndication, multiple lenders extend loans to a single borrower. Each lender has a separate lending relationship with the borrower, with one of the lenders acting as the 'lead lender' or 'lead manager'. As opposed to the case of loan participations, where only the originating lender is a party to the loan agreement with the borrower, in the case of syndicated lending, the syndicated members have a direct relationship with the borrower and are named in the loan documentation.

Each lender in the case of syndicated lending assesses the borrower and is involved in negotiation of the loan terms and conditions. In the case of loan participations, however, the participating banks to whom the participating rights were subsequently sold to would have no say in the underlying terms and conditions of the loan, which was decided by the originating lender.

Another point of difference is that in syndicated lending involves common documentation and direct co-lending by the lenders to a single borrower, whereas loan participation agreements are indirect lending arrangements wherein the originator sells participation rights post origination[36].

Syndicated lending is mostly documented using the standard templates of the Loan Market Association.

In a Hong Kong ruling in the matter of *Charmway Hong Kong Investment v Fortunesea (Cayman) Ltd & Ors* [2015] HKCU 1717, the High Court held that minority lenders in case of syndicated loans cannot pursue default rights in absence of the consent of the majority. The court equated a syndicated lending with participation rights. However, subsequent to the ruling, the Loan Market Association amended Clause 2.3 of its Investment Grade syndicated loan agreement, to clarify that each lender in the facility will have the right to individually enforce the clauses.

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[34] https://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2240&context=wmlr

[35] https://www.bis.org/publ/qtrpdf/r_qt2203c.pdf

[36] Joseph J. Norton (1996), "International Syndicated Lending: The Legal Context For Economic Development in Latin America" - https://scholar.smu.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1665&context=lbra

Conclusion

Loan participations have been a very common practice in India and other countries. Syndicated lending is typically used in case of larger value loans for the purpose of spreading the risk. The use of syndicated lending seems quite common in case of leveraged loans. Co-lending, however, is a term that the RBI used in the context of priority sector loan for the purpose of blending the origination capabilities of NBFCs with the funding strength of the banks, for the purpose of affordable inclusive finance.

However, as the impulse for NBFC-bank partnerships in lending business is quite strong, and banks have recently been eager to build retail portfolios, co-lending seems to be popular as an alternative device to the regulatory discipline of TLE Directions. However, as discussed above, certain current practices in co-lending may need re-examination and further guidance by the regulator.

Our write ups on related topics may be viewed here –

- Participation in loan exposure by lenders - https://vinodkothari.com/2021/10/loan-participations-the-rising-star-of-loan-markets/
- New model of Co-lending in financial sector - https://vinodkothari.com/2020/11/new-model-of-co-lending-in-financial-sector-scope-expanded-risk-participation-contractual-borders-with-direct-assignment-drawn/
- Presentation on Co-lending Guidelines - https://vinodkothari.com/wp-content/uploads/2020/11/Presentation-on-Co-lending-guidelines-final-1.pdf
- One stop RBI norms on transfer of loan exposures - https://vinodkothari.com/2021/09/rbi-norms-on-transfer-of-loan-exposures/
- FAQs on Transfer of Loan Exposure - https://vinodkothari.com/2021/10/37064/

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