Similar objectives, subtle differences

The treatment of secondary trading of transferred loans is different in England and New York in some surprising ways

This article is part of a series comparing and contrasting New York and English law and market practice relating to syndicated lending.

In the October 2009 issue of IFLR, we described certain differences between New York and English law and practice relating to the transfers of interests in loans by means of participations (in New York parlance) or sub-participations (in English parlance). This article discusses secondary trading that creates direct contractual privity between borrowers and transferees. The primary loan documentation forming the basis of comparison is the Primary Market Model Transfer Provision of the Loan Syndications and Trading Association (LSTA) and the senior multicurrency term and revolving facilities agreement for leveraged acquisition finance transactions of the Loan Market Association (LMA).

There are differences between New York law and English law in the legal concepts underlying the nature of the debt sale. The importance of whether an obligation to lend has been transferred (as characterised in New York) or has been novated (as characterised in England) is most relevant in a secured lending transaction where security is created over assets in a jurisdiction that does not recognise the concept of a trust, since the security for loans made pursuant to a novated commitment could be at greater risk for junior treatment.

Our analysis of the LSTA and LMA leveraged forms, as well as the law and practice that surround their use, indicates that although the procedures may differ, the aim of promoting free marketability of assets is common on both sides of the Atlantic. To this end, both forms seek to enable transferors to transfer their rights and obligations with the minimum of administrative burden to a wide range of potential transferees. Although the practice is not completely uniform within the New York or English market, as a generalisation the principal difference is that in New York the administrative agent, any fronting bank and the borrower are more likely to have rights to approve transferees on a case-by-case basis, while in the English market any protection afforded those parties is more likely to be accomplished by granting the borrower consultation rights and by defining in the primary loan documentation who may be permitted transferees.

This difference, and the relatively broad definition under the LMA leveraged form ("another bank or financial institution" or "a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets"), could lead one to conclude that in the trade-off between enhancing liquidity on the one hand and protecting borrowers, administrative agents and fronting banks on the other hand, the English market tilts slightly more in favour of the former goal while the New York market tilts slightly more in favour of the latter.

Comparing legal concepts

In New York, assignment is the legal term used to refer to the transfer of rights, such as the right to receive payments on a loan, and delegation is the legal term used to refer to the transfer of obligations, such as the obligation to make loans under a credit agreement. However, in practice the term assignment is generally used loosely to include both. In support of a public policy favouring free alienation, New York common law permits assignments of rights to payment in the absence of contractual prohibitions to the contrary. Even further, Section 9-408 of the New York Uniform Commercial Code (NYUCC) renders generally ineffective as between assignor and assignee any contractual restriction on the assignment of such rights, although the failure to notify a borrower of any such assignment would permit the borrower to discharge its obligation by paying the assignor and the failure to obtain from the borrower any contractually required consent may have further implications described more fully below. When obligations are delegated, the transferee is not legally bound to perform those obligations unless it assumes them, and even then the transferor is not released from those obligations unless the borrower and any other person to whom those obligations are owed agree to such release.

One of the interesting cases to flow from the Enron bankruptcy (*In re Enron Corp. et al*, 2007) made a further distinction in modes of transfer. The case addressed the question of whether improper conduct by the transferor of a loan in its relationship with the borrower, where that conduct would have resulted in the equitable subordination or disallowance of that loan in the borrower's bankruptcy, tainted the enforceability of the loan in the hands of a subsequent transferee who acted in good faith. Holding that "a personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but will not travel to the transferee if the claim is *sold* (emphasis in original)", the district court remanded the matter to the bankruptcy court to determine whether the claim had been assigned or had been sold. While the case brought immediate relief to the secondary loan market by reversing the bankruptcy court's initial decision that the legal infirmity always followed the claim, it created uncertainty by placing great importance on the precise mode of transfer without providing clear guidance as to how to distinguish between an assignment and a sale. This uncertainty has not yet been resolved.

Under English law, rights can be transferred from one obligee to another. Thus, as under New York law, the transfer of outstanding loans from an existing lender to a new lender is rather straightforward. However, as a matter of law, obligations – such as the obligations to lend money to a borrower and to indemnify an administrative agent – cannot be transferred from one obligor to another. The substitution of one lender for another under a credit agreement in respect of such obligations is characterised under English law as a novation of those obligations. So the obligations of the existing lender are terminated and new, but identical obligations are undertaken by the new lender. The implications of new obligations being created can be significant, particularly in a secured transaction. For example, the security for loans made pursuant a novated commitment may be subject to a lower priority than loans made by other lenders pursuant to continuing commitments under the same credit agreement, and may be subject to greater risks from intervening security, may require re-registration and give rise to new hardening periods under applicable insolvency laws. Under New York law, any change of obligors or obligees under a contract might also be considered a technical novation insofar as the parties are concerned, but such a novation in this context would not have the legal effect of terminating and then resurrecting obligations and thereby jeopardising security.

The use of trusts in English-law secured financings enables transferees to become part of a fluctuating body of beneficiaries of the trust in which the security interests are held independently of the mechanics by which they acquire or undertake commitments to make loans, and such use can therefore mitigate or eliminate the risks associated with novations. However, the efficacy of a trust structure is vulnerable where security is created over assets in jurisdictions where trusts are not recognised, and it is in this context that the LMA leveraged form of assignment agreement developed. Since an assignment of a loan is accompanied by any related security without impairing its priority, a transfer by means of an assignment protects the transferee against the risks described above that are inherent in novations, at least in respect of amounts then outstanding. Furthermore, new monies lent by an assignee rank ahead of intervening security on the basis that subsequent disbursements are tacked onto the original disbursement under section 94 of the Law of Property Act 1925. If at the time of the subsequent disbursement the assignee has notice of the intervening security, the subsequent disbursement will not be tacked on to the earlier disbursement in the absence of an agreement from the holder of the intervening security, unless the assignee is obligated to make further disbursements.

There are two types of assignment under English law: legal and equitable. The requirements for a legal assignment include that the entire amount of the debt be assigned. Thus, unless a lender assigns the entire amount of its loan, this requirement will not be satisfied and the assignment will be an equitable assignment. The biggest consequences of this in practice are that an equitable assignee takes its interest subject to equities and defences available to the borrower (raising issues not dissimilar to the infirmities referred to above in the context of New York law) and the assignee cannot enforce its claim against the borrower without joining the assignor in the proceedings because the assignee cannot give valid discharge to the borrower.

In secured European financings, the problem of recreating the obligations and related security is often mitigated through a parallel debt structure. Alongside the individual debts owed to the lenders, a parallel debt for the total amount of the loan is created, owed to the security agent *in its individual capacity* thereby seeking to side-step the direct effects of transfers by lenders. The security is then granted to the security agent in its individual capacity to secure the parallel debt and the security agent in its individual capacity assumes obligations to share the proceeds of realisation of the security with the then existing lenders. The efficacy of this technique varies across European jurisdictions.

Key provisions of the LSTA and LMA forms

The LSTA form and the LMA leveraged form are substantively similar. They allow transfers in whole or in part, partial transfers (unless made to existing lenders or their affiliates, including affiliated investment funds) must satisfy minimum amount requirements, exclude transfers to natural persons, and consents (in the LSTA form) are required from the administrative agent for transfers to new lenders under the relevant tranche and (in both forms) from any letter of credit issuer and/or other fronting bank for transfers that result in their credit exposure to the transferee. The principal commercial difference between the forms relates to the nature of the borrower's approval rights over transferees.

The LSTA form requires the consent of the borrower to any transfer, except for (a) transfers made to existing lenders and their affiliates, including affiliated investment funds or (b) transfers made at a time when an event of default exists. The form itself contemplates that the parties will negotiate whether any event of default or only certain events of default result in the disenfranchisement of the borrower. While the negotiation is of course influenced by bargaining leverage and prevailing market practice, the more prevalent approach is to refer to any event of default; and in the cases where only certain events of default are specified, those events of default tend to relate to bankruptcy, insolvency and payments. A point to note is that, in addition to the commercial considerations underlying requirements for consent from the borrower (and, as noted above, the administrative agent and, where applicable, any fronting banks), the fact that consent is required for transfers can be one important feature of commercial bank loans that distinguish them from securities and therefore remove them from the purview of securities regulation.

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Under the LMA leveraged form, transferors are required only to consult with the borrower for a specified period of time, but consents are not required. However, the consultation requirement does not apply when the transferee is, is affiliated with or is a fund related to, an existing lender or when an event of default exists. (Distinctions generally are not made based upon the type of event of default.) However, market practice frequently deviates from the LMA leveraged form by requiring a borrower's consent for all transfers; and indeed the variation of the LMA leveraged form used for investment grade financings includes the requirement for consent rather than consultation.

Where consent is required, both the LSTA form and English law loan documentation typically require that the consent of the borrower not be unreasonably withheld or delayed and that consent is deemed to have been given if it is not refused within a specified period of time. (The deemed consent approach was adopted by the LSTA earlier this year.) The most relevant cases decided under New York law interpreting reasonableness are in the landlord-tenant context. These cases establish that the transferor and the transferee, rather than the borrower, bear the burden of proof in showing that the withholding of consent is unreasonable. However, to be reasonable, consent may be withheld only on the basis of objective factors. Such factors could presumably include, for example, the ability of a transferee to fund advances under an outstanding loan commitment, materially increased costs to the borrower that might result from yield protection or tax gross-up provisions in the credit agreement, illegality, and whether the transferee is a business competitor of the borrower. On the other hand, a borrower that conditioned its consent on a reduction in its interest margin or the payment to it of a fee is not likely to be regarded as acting reasonably.

There is very little English case law addressing the question of whether a borrower has acted reasonably in withholding its consent. The only case directly on point settled before judgment was handed down. In practice, any court evaluating the reasonableness of a refusal will look to the facts of the particular case and is likely to consider the same types of factors referred to above that would be relevant to a New York court. As in New York, landlord and tenant cases establish that consent may be refused in order to protects rights under the lease, but not to serve another commercial purpose. Based on existing cases, there does not appear to be any discernable difference between how "unreasonable" is likely to be interpreted under New York and English law in this context.

Because the English market is less likely to provide borrowers with consent rights over specific transfers, the credit documentation in this market instead defines upfront what entities may be eligible transferees. In 2001 the then-current LMA documentation permitted transfers only to lenders that were banks or financial institutions. In light of the uncertainty that existed at the time over the meaning of financial institution, and under pressure from its members to expand the list of eligible transferees in order to increase liquidity in the secondary loan market, the LMA expanded the scope of eligible transferees under its leveraged form to permit transfers to "another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets". Ironically, when the meaning of financial institution was finally given extensive consideration in 2005 in *The Argo Fund Ltd v Essar Steel Ltd* [2005], it was held to mean an institution "having a legally recognised form or being, which carries on its business in accordance with the laws of its place of creation and business and whose business concerns commercial finance" – a broader scope than that adopted by the LMA in 2001.

Both the LSTA form and the LMA leveraged form restrict the ability of the borrower, its subsidiaries and its other affiliates to acquire the borrower's debt under the credit agreement. While there have been developments in both the New York and English markets on debt buybacks, these developments have not resulted in changes to the LSTA form or LMA leveraged form of transfer provision.

Failure to comply with transfer restrictions

Under New York common law, an agreement prohibiting an assignment of a right to receive money is regarded as a mere covenant the breach of which may give rise to money damages, unless the agreement states that that the non-complying assignment is void. (*See, for example, Sullivan v International Fidelity Ins*) Accordingly, the LSTA form expressly states that an improper purported assignment is null and void, and it goes on to state that such a transfer will be treated as a participation. As noted above, Section 9-408 of the NYUCC renders generally ineffective any contractual restriction on the assignment of such rights. However, paragraph (c) of that Section provides that, if the restriction on assignment would be effective under other applicable law, then the assignee may not enforce the obligation against the borrower and the borrower is not required to recognise the assignment. Thus, because under New York common law the LSTA form rendering the improper assignment void would be upheld, the borrower would not be bound by the assignment even though it would be effective as between the assignor and the assignee.

This appears to be the rough equivalent of an equitable assignment under English law. A restriction on assignments is generally regarded not as a prohibition on alienation of assets (for such a prohibition would be void as a matter of public policy) but as a condition to the debtor's obligation, relieving the debtor from an obligation to the assignee. In cases where the assignment is of no effect between the debtor and the assignee it is difficult to see how a claim for damages can arise, although this does depend on the construction of the clause.

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Champerty

The offence of champerty is a common law concept found in both English and New York law. Although the doctrines are slightly different in the two jurisdictions, the general intent is to prevent the commercialisation of, or trading in, lawsuits. In both jurisdictions, a champertous assignment is void. Champerty has been of interest to some distressed debt investors because their purchases of defaulted loans might theoretically be construed as effective purchases of rights to sue borrowers.

The New York laws relating to champerty are codified in sections 488-489 of the New York Judiciary Law, under which a corporation or association may not "solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon." Although a historical basis of champerty is to prevent lawyers from buying claims so that they can recover their own fees in an enforcement action, the literal language of the New York statute is broad. A recent case, *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors Mortgage Pass-Through Certificates v Love Funding Corporation* considered whether an assignment of representations and warranties related to purchased loans and the related remedies for breach thereof from a prior holder to a subsequent holder of those loans was champertous, where such assignment gave to the subsequent holder the right to sue for claims beyond what it could collect on the loans. Due to the importance of this case in the secondary loan market, the LSTA filed an *amicus curiae* brief. This assignment at issue occurred several years after the transfer of the loans themselves to the subsequent holder, as part of a settlement between the assignor and the assignee to give the assignee claims against a prior holder of those loans even further upstream in the ownership chain than the assignor. Although the case was heard first in the US federal court system, the United States Court of Appeals for the Second Circuit decided that the case turned on "significant and unsettled questions of New York law" and referred the relevant questions to New York State's highest court. These questions included whether the test for champerty is based on the "sole" or the "primary" purpose of the assignee to bring a lawsuit and whether the acquisition of claims by an assignee relating to debt in which it had pre-existing proprietary interest is proper regardless its intent concerning a lawsuit. The Court of Appeals decided the second question in the affirmative and found that it was therefore unnecessary to address the first question. This narrow holding thus leaves for another day some continuing issues of potential interest for buyers of distressed debt.

Under English law, the offence exists at common law, except for certain statutory exceptions. The House of Lords considered certain aspects of champerty in *Giles v Thompson*, wherein Lord Mustill made it clear that in considering champerty courts should look to its origins "as a principle of public policy designed to protect the purity of justice and the interests of vulnerable litigants". Accordingly, if the facts of the Love Funding case, in which all parties involved in the transaction were sophisticated commercial entities, were to be considered by the English courts, it is unlikely that a claim of champerty would be successful. It is also worth noting that English case law indicates that the assignment of a loan will not be champertous (assignments of debt; *Glegg v Bromley* [1912], *Ellis v Torrington* [1920].

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