INTERNATIONAL FINANCE SPRING 2009

Materials Packet 5

ISSUES IN INTERNATIONAL SYNDICATED LOAN AGREEMENTS III: ASSIGNMENTS, NOVATIONS, SALE OF PARTICIPATIONS

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1. ASSIGNABILITY

We saw when we focused on Elliott Associates that sometimes assignments are challenged on the basis that the assignment breached terms of the original agreement. Another case where such arguments were raised is **Essar Steel v The Argo Fund**, a decision of the English Court of Appeal.[2] This excerpt is from Lord Justice Auld's judgment:

1 This is an appeal by Essar Steel Ltd ("Essar") against a decision of Mr Justice Aikens on 12th April 2005 concerning the meaning and effect of a provision in an unsecured syndicated loan agreement (the "Agreement") made on 7th March 1997 between Essar as borrower and a syndicate of nine banks and financial institutions (the "Syndicate"), restricting the Syndicate members' entitlement to transfer their rights and obligations under the Agreement to entities that are "a bank or other financial institution". The case concerns the purported transfer by some of the Syndicate members to the Respondent, The Argo Fund Limited ("Argo"), in 2002 and 2003 in the "secondary debt market" of part of the over-all loan drawn down by Essar.
2 The Agreement is the standard 1997 Loan Market Association ("LMA") form, which, at the material time, contained no further definition or elaboration of the term "bank or other financial

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[2] http://www.bailii.org/ew/cases/EWCA/Civ/2006/241.html

institution". In November 2001 the LMA revised the definition by adding to it "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". It did so in order to remove grounds for dispute, illustrated by this appeal, as to the range of entities that could qualify as a "financial institution" within this provision. However, there are apparently many syndicated loan agreements, in addition to this one, in the 1997 LMA un-amended form that are or may be the occasion of similar dispute as to the range of institutions to which syndicate members may transfer debts in the secondary debt market.

3 The agreed expert evidence before the Judge indicated that restrictions on transferability in such agreements were not uncommon in 1997 when this Agreement was made and that there were a number of reasons why potential parties to such agreements might wish some such restriction. These included the preservation of a continuing relationship between borrower and lenders and between the lenders themselves; minimisation of costs of administration of the loan and to retain replacement lenders who would be likely to observe the law and regulatory guidelines. The question for the Court is whether and to what extent the restriction in this case, in its unadorned 1997 form, was intended by Essar and the Syndicate members to serve such or other purposes and, more particularly, whether it served to exclude Argo from claiming repayment as a transferee under the Agreement...

5 Argo is an investment company incorporated in 2000 in the Cayman Islands, which, as part of a small group of companies, holds and manages funds and the investments purchased with them. At all material times, it had a portfolio of debt, including bonds, loans, letters of credit and promissory notes, mainly purchased in the secondary debt market from other institutions. Argo described itself as a "Global Emerging Markets Debt Hedge Fund", and had as its investment aim the securing of higher returns for investors at the more risky end of the market, though it had sometimes acted as an original lender. ...

18 Clause 27 of the Agreement provided for two modes by which Syndicate members could pass their rights under the Agreement to another, one by way of assignment on notice to Essar, the other by way of transfer, which also operated to transfer obligations as well as rights, amounting to a novation. As to assignment, the Agreement imposed no restriction save as to documentation and notice to Essar, clause 33.1 expressly providing that, where the context permitted, "any 'Bank'" should be construed so as to include "without limitation … Transferees and assigns in accordance with their respective interests". As to transfer, the context did not permit such limitless construction, since clause 1, the interpretation clause, defined a "Transferee" as:

"a bank or other financial institution to which [a Syndicate member] seeks to transfer all or part of such [member's] rights and obligations hereunder in accordance with the provisions of this Agreement." [my emphasis]

19 Clause 27 provided, so far as material:

"27.1 This Agreement shall be binding upon, and inure to the benefit of each party hereto and their respective successors, Transferees and assignees. … Any Bank may, subject to the execution and completion of such documents as the [Syndicate members'] Agent may specify and with notice to the Borrower, assign all or any of its rights and benefits hereunder or, subject to the payment to the Agent of a transfer fee of $250, transfer in accordance with Clause 27.2 all or any of its rights, benefits and obligations hereunder.

27.2 If any Bank wishes to transfer all or any of its rights, benefits and/or obligations hereunder, then such transfer may be effected by the delivery to the Agent of a duly completed and duly executed Transfer Certificate in which event …:

(i) to the extent that in such Transfer Certificate the Bank party thereto seeks to transfer its rights and obligations hereunder, the Borrower and such Bank shall be released from further obligations towards one another hereunder and their respective rights against one another shall be cancelled (such rights and obligations being referred to in this Clause 27.2 as 'discharged rights and obligations');

(ii) the Borrower and the Transferee party thereto shall assume obligations towards one another and/or acquire rights against one another which differ from the discharged rights and obligations only insofar as the Borrower and the Transferee have assumed and/or acquired the same in place of the Borrower and such Bank; and

(iii) … the Transferee and the other Banks shall acquire the same rights and assume the same obligations between themselves as they would have acquired and assumed had the Transferee been an original party hereto as a Bank with the rights and/or obligations acquired or assumed by it as a result of such transfer"...

27 Mr Laurence Rabinowitz QC, on behalf of Essar, maintained that the Judge, having correctly concluded that the Agreement, in keeping with commercial sense, imposed some restriction as to permissible transferees, wrongly failed to give effect or proper weight to that conclusion when considering what the Agreement meant in its use of the term "bank or other financial institution". At the heart of Mr Rabinowitz's submission was his contention that that expression, read in its commercial context, limited transferees to those who were "bank-like" lenders active in the primary debt market, whose characteristics would thus be indicative of substance and integrity. It could not, he submitted, include institutions other than banks whose only or main involvement in debt was in trading it, that is in the secondary debt market.

28 On this issue, the Judge began by considering the commercial context in which the Agreement was made in 1997. On the agreed expert evidence before him, it was one in which trading by banks, their subsidiaries or affiliates in loans in the secondary debt market, for the purpose of managing a portfolio of debt or for other reasons, was at that time common. Non-banking institutions also participated in such secondary trading in debt at that time, but less commonly. Against that background, the Judge held that the parties to this 1997 Agreement must have intended that the class of potential transferees should be wider than that of bodies fitting the definition of a "bank".

29 As to how much wider, the Judge nevertheless took as his starting point the extent to which, if at all, the institution in question "shared" characteristics with a bank – a form of ejusdem generis approach. Thus, in paragraphs 36 and 37 of his judgment, he reasoned:

"36. It is clear that the parties intended that the class of potential transferees should be wider than bodies that fit the definition of 'banks'. In my view, 'banks' and 'other financial institutions' were intended by the parties to denote two different types of entity; otherwise the expression 'banks or other financial institutions' would be a tautology. …

37. It is possible to argue that 'other financial institutions' must share many common characteristics with banks or only a few characteristics with banks. Is there any indication in the Agreement that points to an intention of the parties that the key common characteristic is that of providing finance in the primary lending market and being regulated and accountable? In my view, there is not and … [counsel for Essar] could not point to anything specifically in support of his preferred construction."

30 In those passages, the Judge appears to have taken what he described as a possible premise or necessary starting point for his analysis, namely that, although an "other financial

institution" meant something "different" from a "bank", it nevertheless had to have some of its characteristics. He did not seemingly consider that an "other financial institution" without any characteristics peculiar to a bank could have been intended by the parties. Thus, as his ensuing analysis in his judgment makes clear, his starting point was that one of the bank-like characteristics an "other financial institution" should have for the purpose was that of a lender of money. The question for him on Essar's case was whether it had also to be an original lender, that is in the primary lending market as distinct from becoming one by, say, transfer or assignment...

43 In my judgment, the Judge correctly concluded that the term "other financial institution" in the expression "bank or other financial institution" need not be a bank or even akin to a bank. Clearly, the disjunctive form of the contractual expression, "bank or other financial institution", allowed for a financial institution that was not a bank, certainly not in the narrow conventional sense of lending money and/or accepting deposits for investment. However, given the use of that expression in a loan agreement allowing the transfer of the rights and obligations of the contract loan to a financial institution other than a bank, the assignment of its rights to anyone, and the known existence of a secondary market in such loans, I can see no basis for the Judge's starting point that one of the characteristics of such an institution was that it had to be a lender, whether in the primary market or otherwise. It is equally beside the point whether a potential transferee is technically a lender as an established trader in loans in the secondary market or, indeed that it would become a lender, if not otherwise qualifying as such, on becoming a transferee under the Agreement.

44 It follows, in my view, that it is equally immaterial in the commercial context of the Agreement whether a transferee is good for the loan monies under it, if, at the time of transfer, the borrower had not drawn them down – the fourth characteristic that the Judge held an "other financial institution" should share with a bank. It would be nonsensical if the meaning of a transferee under this Agreement were to turn on whether, at the time of transfer, the loan had been drawn down. The commercial reality of the Agreement, with its short draw-down period of 45 days and in its provisions as to transfer and to assignment, was that in the majority of cases it was catering for the trading of debts, often distressed debts, in the secondary debt market, that is, after draw-down. In that commercial context there can be no justification for insinuating into the term an "other financial institution", an ability to honour the original loan in the short draw-down period commonly a feature of such syndicated loans. As an exercise of construction, it would, as Mr Howard observed in argument, amount to the tail wagging dog.

45 Equally, it is difficult to see the commercial reality of the arguments advanced by Mr Rabinowitz (and at least in part acknowledged by the Judge in concluding that clause 27.2 imposed some restriction on transfer) in the greater reassurance for all parties in the restriction for which he contended for example, in the approach to and administration of the recovery of the loan. Those who buy debt, distressed or otherwise, are, by the very nature of the transaction and commitments undertaken, likely to have a shared interest with fellow lenders in the orderly payment of interest and or of any staged repayments of capital for which such an agreement or subsequent arrangement might provide and with which the borrower is complying. But where, as in this and many such cases, the borrower is in serious long-term default and its debt has been traded at a significant discount, the commercial reality is that each lender, whether original or transferee (or assignee) will have its own commercial interest in securing speedy or an otherwise effective means of recovery by whatever legal means are open to it. The trading in distressed debt and recovery of their outlay by those who have

contractually secured their right to sell it, and by those who buy it, is necessarily a harsh commercial environment. It is not one in which parties to syndicated loan agreements providing contingently for the trading of debts the subject of them could ordinarily confidently expect or provide at the time of contract for enduring and harmonious relationships.
46 Behind all those considerations is Mr Howard's second main submission on this issue, namely that clause 27.1 of the Agreement, in its provision for the trading of the loans made under it, allowed members of the Syndicate, as lenders, though not Essar, as the borrower, to assign rights under the Agreement. That provision entitled the Syndicate members to assign to anybody the right to recover, in accordance with the Agreement's terms, monies advanced to Essar. It is true that, after assignment and before draw-down, Essar would have retained its rights to call for the loan monies against the Syndicate. It is also true that, after assignment and after draw-down, both Essar and the original Syndicate members would have been subject to certain residual obligations under the Agreement, for example, obligations of Essar to indemnify Syndicate members (clauses 18 and 22) and continuing obligations of Syndicate members in respect of costs of redistribution between them of loan repayments (clause 24), costs of administration (clause 25) and agency fees (clause 26). Even allowing for those residual obligations, there would have been little point in either Essar or the Syndicate members intending or seeking to protect themselves against transfer by one or more of them to a financial institution that was not an established lender of proven worth or one that might not behave "suitably" in the administration and/or recovery of any loan monies transferred. Such protection, if it existed, could simply be set at nought by the Syndicate members selling their share of the debt resorting to assignment.
47 Given the history of this matter, it is a curiosity that the members of the Syndicate concerned and Argo seemingly did not turn their minds at an earlier stage than they have to the assignment route to recovery. If they had done, it would not have been open to Essar to take any point as to Argo's qualification to become an assignee and hence its entitlement to recovery of the loan monies concerned.
48 I should add, for the sake of completeness, that I have considered with care Mr Rabinowitz's recourse to a number of provisions in the Agreement to support his narrow construction of "transfer" within the ambit of clause 27.2. Without going into unnecessary detail, my view is that none of them considered individually or together, supports his contention that a transferee for the purpose of clause 27 must be an institution that lends money in the primary lending market. Such references were in the main clearly short-hand references to the original lenders under the Agreement or, in the event of transfer or assignment under clause 27 and as appropriate, a transferee or assignee, as inclusively defined in clause 33.1, the latter in its context, "without limitation" - that is, anyone at all.
49 For the reasons I have given, I would go further and hold - contrary to the reasoning of the Judge on this issue - that it is not a necessary characteristic of a transferee that its business should include bank-like activities, such as the lending of money, whether on the primary or secondary debt market or otherwise, or indeed that it should exhibit any particular standard of suitability or probity as a financial institution. All or most of Mr Rabinowitz's submissions in this respect turned on the use of the word "bank" and reference to what was expected of it in different contexts after draw-down. However, those few residual obligations of lenders after draw-down are, in my view, insufficient to colour or restrict the range of entities to which debt may be passed in the secondary debt market. In such circumstances – for which the secondary debt market mostly provides - the borrower has had the benefit of the money. It is its substance

and integrity in meeting its repayment obligations, not those of the original or transferee lender's ability to continue to hold the debt that will, in most cases, be the matter for concern.
50 As to "suitability" of a transferee, given the spare terms of the Agreement's definition of "Transferee", its separate provision for unrestricted assignment and its commercial context, the notion of a transferee having to be a sound and respectable lender, whether in the primary of secondary market, was, in my view, clearly outside what the parties could reasonably have intended or expected of the Agreement. If the parties had intended it to provide protection to that effect, they could and would have done so in clear terms. For example, they could have stipulated that it should be a body subject to a particular regulatory regime or regimes, or, as Hallett LJ mooted in the course of submissions, have expressed the restriction as "a bank or other similar financial institution".
51 I, therefore, end up with a broader interpretation than did the Judge of the term "other financial institution" in the expression, "a bank or other financial institution", in the Agreement. In my view, the Judge, in identifying the nature of the restriction imposed by the Agreement on the meaning of a transferee for the purpose of considering whether a putative transferee was entitled to claim repayment of debts of Essar passed to it, adopted too restrictive a meaning. He should have held that it was satisfied by proof that the putative transferee met the broad fifth criterion he identified in paragraph 38 of his judgement, namely having "a legally recognised form or being, which carries on its business in accordance with the laws of its place of creation and whose business concerns commercial finance", and whether or not its business included the lending of money on the primary or secondary lending market.
52 The commercial reality of a dispute such as this is that a lender under a syndicated loan agreement, whether original or by way of transfer or assignment, may and should be entitled to recover from the borrower monies lent when they become due and that the borrower, whether distressed or otherwise, has and need have little interest as to the commercial or financial status of the body to which the role of lender has passed. Here, Essar is a long-standing defaulter in making repayment of a substantial loan provided for by an agreement which, by its very nature, provided for the eventuality of it being traded at a discount as a distressed debt in the secondary debt market. There is no basis, whether in law as a matter of construction of the Agreement, still less of justice, for permitting it to avoid honouring its debt through the device of mounting an attack, well-founded or not, on the financial or commercial character or status of its lender.

The English Court of Appeal also considered restrictions on assignment in **Barbados Trust Co Ltd v Bank of Zambia** in 2007.[3] This excerpt ifs from Lord Justice Waller's judgment (his judgment is reported first, though the other two Law Lords disagree with hi on this point so what follows in this first excerpt) is not the correct statement of the law:

3. BT has brought the action claiming from BoZ .. two principal sums totalling US$ 809,387.02. BT has done so as a beneficiary under a declaration of trust created in its favour by the BoA[4]

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[3] http://www.bailii.org/ew/cases/EWCA/Civ/2007/148.html .

[4] Bank of America.

on 30 January 2004 the day the claim was issued. It has joined BoA as second defendant relying on the procedure which has been recognised in many cases of suing in their own name naming the trustee as a defendant where the trustee refuses to sue in his own name. ..

4. The sums have been an admitted debt as far as BoZ is concerned for many years. The debts arose under an Oil Import facility dated 19 July 1985 (the Facility). By that Facility various banks and financial institutions agreed to make available to BoZ a facility for the issue of letters of credit in the maximum principal amount of $100 million. Bank of America International Limited ("BAIL") was the agent and manager under the facility....

5. The debts have been sold in the distressed debt market, assignors and assignees seeking the consent to assignment from BoZ pursuant to Article 12 of the Facility which is in the following terms:-

"12.01 (A) Each Bank may at any time and from time to time assign all or any part of its rights and benefits in respect of the Facility to any one or more banks or other financial institutions (an "Assignee"), provided that any such assignment may only be effected if (save in the case where the assignee is a member of the same group as the assignor, no such consent then being required) the **prior written consent** thereto of the Borrower shall have been obtained (such consent not to be unreasonably withheld and **to be deemed to have been given if no reply is received from the Borrower within fifteen days after the giving of a request for consent** by a Bank) . . .

(B) If any Bank assigns any part of its rights and benefits in respect of the Facility in consideration of the agreement of the Assignee with such Bank to perform that percentage of such Bank's obligations in respect of the Facility as corresponds with that percentage of its rights and benefits so assigned to the Assignee, then all references in this Agreement to such Bank shall thereafter be construed as references to such Bank and its Assignee to the extent of their respective participations. The Borrower shall thereafter be entitled to look only to the Assignee (to the exclusion of the assignor) in respect of those proportions of the assignor's obligations in respect of the Facility as correspond to the Assignee's participation (and accordingly the assignor's Commitment shall be proportionately reduced and the Assignee shall proportionately assume a Commitment equivalent to such reduction), provided that the Borrower shall not by reason of any such assignment be obliged to make any payment otherwise than to the Agent.

(C) Unless and until an Assignee has agreed with the Agent that it shall be under the same obligations to the Agent, the Manager, the Issuer and the Banks as it would have been under if it had been a party to this Agreement, the Agent, the Manager, the Issuer and the Banks shall be entitled to continue to look to the assignor for the performance of all its obligations in respect of the Facility as if no assignment had taken place and the Agent shall not be obliged to make payment of any sum to which that Assignee may become entitled in respect of the Facility other than to the relevant assignor."...

9. The Assignment to BoA from Masstock was the subject of a "form of confirmation" dated 22 November 1999 sent by BoA. The consideration was 5% of the principal amount of the debt. The assignment was subject to and incorporated the "Standard Terms of Assignment of Loan Assets ….of the Emerging Markets Traders Association" (the "EMTA Terms").

10. By fax transmission sent on 2 December 1999, Masstock sent a "Request for Consent" form to BoZ with copies to BAIL "As agent" and to BoA. It notified BoZ that Masstock proposed to assign their rights and obligations to BoA and continued:-

". . . we request your consent to the foregoing assignment and note that Section 12.01 of the

[Facility] states that your consent shall not be unreasonably withheld".

11. The judge held that the request was received and that BoZ did not respond for reasons which matter not. It follows that deemed consent would take place after 15 days i.e. 17th December 1999. In the meanwhile on 10th December BoA prepared a "closing certificate" for the Masstock transaction. It was also said to be subject to EMTA terms, and the Settlement dates and the Effective Dates were both stated to be 10 December 1999. The description of Asset in "Exhibit A-1" referred to the principal amounts and added in typescript "Consent: The prior written consent of BoZ is required to transfer the Assigned Credits." On return of the certificate Masstock added in manuscript "As per Article 12.01(A). Such consent shall be deemed to have been given if no reply is received from BoZ …after the giving of the request for consent."

12. Notice of assignment signed by Masstock and BoA although dated 10th December was sent on about 14th December to BoZ giving notice of the assignment and stating that as between "the undersigned, the assignment is effective from December 10 1999…."

13. The EMTA terms I can explain in the words of the judge:-

"29. The (applicable) EMTA Terms assist in explaining the paperwork employed for the trade. They provided that "Seller and Buyer shall be considered to have entered into a binding oral agreement regarding an Assignment on the Trade Date". As between Bank of America N.A. and Masstock the Trade Date was 3 November 1999.

30. The EMTA Terms required a Written Confirmation to be sent and returned by the recipient. If the recipient does not agree the terms shown he must notify the sender in writing "in which case the parties shall determine the correct terms and the party sending the Confirmation will send the recipient a corrected Confirmation". That was done by the "Form of Confirmation" sent by Bank of America N.A. to Masstock dated 22 November (paragraph 13). It appears, however, that it was not returned by Masstock.

31. The EMTA Terms provided that:

"When executed and returned by the recipient (or if not objected to by the recipient within two Business days after receipt) a written Confirmation will constitute a binding Agreement between Buyer and Seller."

32. Section 1(c) provided:

"Closing Certificates. On or before the Settlement Date, Buyer and Seller will each execute and deliver a Closing Certificate for such Assignment. A Closing Certificate, when executed by both Buyer and Seller, shall, together with these Standard Terms … constitute a final and binding agreement between Buyer and Seller and shall supersede all prior oral or written agreements or statements by the parties with respect to the related Assignment."

33. Section 1(d)(C) provided that the Seller would send a Request for Consent to the Obligor as soon as practicable "after Buyer notifies Seller of Buyer's agreement to the draft Closing Certificate (but in any event no later than the Effective Date) …."

34. Section 2 provided, in effect, for completion of the sale between Buyer and Seller on the Effective Date or the Settlement Date, as the case might be. Both dates were, in this case, 10 December, 1999.

35. Section 3 addressed "Consents; Substitute Assignments; Unwinds". So far as material, it provided:

"(a) It is not a condition precedent to performance by the parties of their obligations in respect of any Assignment that all Consents be obtained on or before the Effective Date.

(b) Seller and Buyer shall use all reasonable efforts to obtain any Consent required for each

Assignment as soon as possible after the Effective Date.

(c) If any such Consent is denied, any party with notice of such denial shall promptly give notice thereof to the other, and Seller and Buyer shall use all reasonable efforts to remedy the cause of such denial within 30 days after each has received notice of such denial (such 30th day being the "Unwind Date")…."

36. In the event consent was denied, the parties could agree on a substitute asset or substitute seller or buyer and if that was not possible they were to agree either that the Buyer was to have a 100% beneficial interest with the Asset "automatically deemed reassigned" subject to that interest to the Seller as of the Effective Date or that the Buyer would pay the Seller the "Unwind Market Price" upon which the Asset "shall be automatically deemed reassigned by Buyer to Seller".

37. Section 5(b)(C) provided (with my emphasis) that the Seller "represents and warrants as of the Trade Date and the Effective Date that"

"on the Effective Date, (i) Buyer will receive marketable title to such Asset free and clear of all Liens and other claims; (ii) Buyer will be the beneficial owner of the Asset; (iii) subject to any consent or eligibility requirement contained in any Debt Agreement, (1) Buyer will be entitled to be the record owner of the Asset …."

14. BoZ's argument is simply that by Article 12 BoZ were entitled to have 15 days to consider whether to give consent, and that consent cannot be deemed to have been received until 15 days after the request i.e. until 17th December. Thus the argument is prior written consent was not received and the assignment is invalid as between BoZ and BoA.

15. The judge rejected this submission. He did so, on the basis that the EMTA terms contemplated the continuing need for consent despite the binding nature of the agreement as between BoA and Masstock. So he held, undoubtedly rightly, that as between Masstock and BoA it would be impossible to contemplate either being able to say that the assignment was invalid. Thus the judge emphasised it was not open to either to use the unwinding procedure. He then said at paragraph 51 and 52 as follows:-

"51. The issue is whether or not, granted that when the original Closing Certificate was completed no consent had been obtained and the Notice of Assignment purported to give notice of an assignment effective on December 10 and so also before any consent had been obtained, nonetheless when consent would have been deemed to have been given on 17 December it was effective to complete the acquisition of the Asset by Bank of America N.A. There is an artificiality in treating such a deemed consent as a "prior" consent; but there is, to my mind, a greater artificiality in ignoring the deemed consent when the Assignment plainly addressed the need for it and can, and I think should, be read commercially as providing for it to be effective when given or deemed to be given.

52. In my judgment, the proper construction of the Assignment is that it took effect to complete the transfer of the Asset to Bank of America N.A. upon receipt of actual or deemed consent such that the consent can properly be treated as given "prior" to the assignment."....

18. On construction of the assignment, I agree with the judge that a recognition, expressly in the terms that prior written consent or deemed consent was required meant that, until it was obtained or deemed to be obtained, the assignment was not effective.

19. As regards the deeming provision I would put the matter this way. The deeming provision undoubtedly deems consent to have been given <u>in writing</u> when it has not been. Where, as a matter of context, it is well known that deals may be done for which consent will be sought after their effective date, I can see no reason why that consent should not also be deemed to be

prior. I accept the word in parenthesis to which the word deemed applies is simply "consent" and Mr Handyside submitted that the use of the word was deliberate and thus did not refer to prior written consent. I disagree. In its context it is the required "prior written consent" to which it is referring: it is prior written consent which is deemed to have been given if BoZ choose not to reply. That, in my view, makes good commercial sense, since if BoZ chose to reply and refuse consent, the unwinding procedure under EMTA terms would be available, or, if it took the point within fifteen days that "prior" consent had not been obtained, the parties to the assignment could put that right or unwind. It makes no commercial sense in the context of the EMTA terms that, years after the event, and despite BoZ appreciating that their consent should have been "deemed" to have been given, BoZ should be entitled to answer the assignee's claim by reference to the date when negotiations, subject to the obtaining of consent, had been completed.

The other two judges in the Court of Appeal disagreed with Lord Justice Waller on the meaning of the deeming provision. Lord Justice Rix said:

59. ...where an assignment precedes written consent, then, subject to waiver in circumstances where the debtor knows that the assignment has jumped the gun, it will always be open to the debtor to argue that the assignment is ineffective. That is a potential trap for the future, and parallels the misfortune hypothesised by Waller LJ at the end of para 19 above: however, on the wording of article 12.01(A) it seems to me to be inescapable. Moreover, despite such possible unfortunate consequences, there is a commercially sound reason for the requirement of "prior" consent: it polices the process. If the debtor has to consent in advance, or is to be given a 15 day opportunity to consider his position, then the bank that wishes to assign has to give notice before it effects an assignment. And where a bank wishes to assign, there is no insuperable difficulty if its proposed assignment is made conditional upon prior consent being obtained or being deemed to have been obtained: generally speaking, the consent will be there by the end of 15 days.

60. I say "generally speaking", because there are in any event problems of construction which may arise where the debtor answers the request within fifteen days, but either without a positive written consent or with an express but unreasonable refusal. In such circumstances, when is the article 12.01(A) proviso fulfilled? That question has not really been debated before us, but it can be seen that the contractual language presents a problem if there is an unreasonable refusal of consent within the fifteen day period. In such a case there is no actual consent, nor is there apparently that "no reply" for 15 days which is the stated condition for deemed consent. A similar problem arises where the debtor replies within the fifteen days, but without either giving or withholding consent. I would hazard the thought that both these problems could be solved if "no reply" were stretched to encompass "no positive reply". On that basis, the unreasonable refusal (which after all is ineffective) and the merely holding reply (which after all is the equivalent of no reply in circumstances where the debtor is expected to reply within 15 days or risk being deemed to have given his consent) could both be viewed as "no reply". The fifteenth day would therefore become in all such cases the day by which there has either been actual consent, or deemed consent.

61. In this connection I agree with Waller LJ that deemed consent is deemed "prior written" consent ("such consent"); but I respectively differ from him in his conclusion that the deemed consent which comes from a 15 day failure to deal properly with a request for consent is

therefore a sufficient consent within the proviso whenever it occurs. In my judgment, it is for just this reason that one has to ask when such deemed prior consent occurs. The obvious answer is at the end of the fifteenth day, which in the present case is taken to be 17 December 1999. That is what the judge said (at para 19: "Therefore under Article 12.01(A) Bank of Zambia would have been deemed to have consented to this Assignment on 17 December 1999"). I reject Mr Brodie's alternative submission that consent is deemed to have been given on the day of its request rather than at the end of the 15 day period: that is simply not justified by anything within article 12.01(A).

62.The question then arises whether the assignment in issue, which for present purposes is taken to have been "effected" on the "Effective Date" of 10 December, is a valid assignment within the proviso with the benefit of "prior" consent. If, however, prior consent has only been deemed to have been given on 17 December, it is plainly not that deemed consent which is contemplated by the clause. After all, ex hypothesi, the request which triggers the 15 day period must have been made prior to the effecting of the assignment, for where there is actual prior written consent that is what will have happened. If therefore actual written consent must have been requested and made prior to the effecting of the assignment, then a fortiori a deemed consent must have been. Otherwise a request could be made at any time, and after a 15 day period without any reply, there would be deemed "prior" written consent. If that were right, then it ought to follow that actual consent could have been requested at any time, even years later. In one sense of course it could: if the parties agree to give retrospective effect to an ineffective assignment, they can, I suppose, do so: and there will in any event be a waiver of the requirement of "prior" consent where such consent is retrospectively obtained with knowledge of the dates in question. However, such after-acquired actual consent is plainly not "prior" consent, unless the assignment is re-effected afterwards, as it might be.

Lord Justice Hooper said:

123.By taking an assignment of what I shall call the Facility, Masstock agreed with BoZ, by virtue of Article 12.01(A), not to assign the Facility without the prior written consent of BoZ. Masstock tells BoZ on 14 December 1999 that "the assignment is effective from December 10 1999". That mirrored the terms of the agreement between Masstock and BoA. At that time, it is agreed, BoZ had not consented. Article 12.01(A) provides that any "assignment may only be effected if ... the prior written consent" of the BoZ has been obtained. It had not. That to my mind is sufficient to resolve the issue, subject to the "deemed" argument...

124. Article 12.01(A) provides that an assignment to a bank or other financial institution "may only be effected if the prior written consent of the Borrower shall have been obtained (such consent not to be unreasonably withheld and deemed to have been given if no reply is received from the Borrower within 15 days after the giving of a request for consent by a Bank) ...". Waller LJ and Rix LJ interpret "such consent" to mean "prior written consent". I cannot agree. What must not be unreasonably withheld? The answer to that is in my view: "consent". "Such consent" means "the consent of the Borrower". An oral consent would not be sufficient. If only an oral consent was given then, after 15 days from the request, the Borrower's consent will be deemed to have been given. It is not the Borrower's "written" consent which is deemed to be given. And, in my view, it is certainly not the Borrower's "prior" consent which is deemed to have been given. Why, I ask rhetorically, would the drafter be deeming that a "prior" consent had been given? Prior to what? It does not seem likely to me that those responsible for the drafting

had in mind that an assignment which was ineffective because of lack of prior written consent becomes effective because of the deeming provision from the date of the assignment (Waller LJ) or from the 15th day after the request for consent (Rix LJ).

Question: Which of the judges was correct?

In this case the Court of Appeal also considered whether it would be possible to get round restrictions on assignment by making a declaration of trust with respect to an interest in a loan. The judges agreed that this was a matter of interpretation of the contract, but that the contract in this case did not prohibit such action. Here is Lord Justice Rix on this question:

88. The ineffectiveness of the assignment in breach of a prohibition on assignment is understandable. It is not merely a matter of contract but of property. Although the would-be assignor has legal title to property in the form of a chose in action, he lacks the power, because of the terms on which the property is held, to transfer that property so as to entitle the transferee to exercise those contractual rights himself against the other party to the contract. However, he does not lack the power to render himself a trustee in equity of the property concerned. He would only do that if the prohibition on assignment extended as far as prohibiting a declaration of trust.

Lord Justice Hooper had a perhaps more nuanced view of this issue:

139 Whilst I agree with Rix LJ .. that the article 12.01(A) limitations on assignment do not prevent BoA from creating a declaration of trust in favour of BT (as it purported to do by the documents set out by Waller LJ at paragraphs 22 and following), I disagree with the proposition which finds favour with Waller LJ (and with Rix LJ "on balance"), that the terms of Article 12.01(A) permit BT to bring the claim against BoZ. The clause prevents an assignment to a body such as BT and must therefore be construed so as to prevent BT from enforcing the debt directly against BoZ. The clause cannot be circumvented by the device of a declaration of trust and the use of the Vandepitte procedure. To require those who draft contracts of this kind to take steps to avoid the device used by BoA and BT to get round the non-assignment clause would be unduly onerous and, as I have said, would only benefit lawyers.

2. WHAT CONSEQUENCES FLOW FROM ASSIGNMENT?

Assignments raise many different issues. In the Enron bankruptcy proceedings Judge Arthur Gonzalez held that a claim that would be subject to equitable subordination in the hands of the transferor is subject to equitable subordination in the hands of a transferee.[5] Market participants criticized the decision as importing

[5] Enron Corp. v. Avenue Special Situations Fund, II, LP (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005)

uncertainty into the loan trading market. On appeal to the SDNY, Judge Shira Scheindlin vacated Judge Gonzalez' decision in **Enron v. Springfield Associates:** [6]

Under the doctrine of equitable subordination . . . a bankruptcy court may subordinate a particular claim if it finds that the creditor's claim[], while not lacking a lawful basis nonetheless results from inequitable behavior on the part of that creditor.'" Equitable subordination is specifically authorized by section 510(c), which provides, in pertinent part,

> [A]fter notice and a hearing, the court may . . . (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . .

Although Congress included no explicit criteria for equitable subordination when it enacted [section] 510(c)(1), the reference in [section] 510(c) to 'principles of equitable subordination' clearly indicates congressional intent at least to start with existing doctrine." At the time of enactment, courts had uniformly adopted the three-pronged test set forth by the Fifth Circuit in In re Mobile Steel Co. for evaluating whether to equitably subordinate a claim: (1) the subordinated creditor must have engaged in "some type of inequitable conduct"; (2) the misconduct must have "resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant"; and (3) equitable subordination of the claim must "not be inconsistent with the provisions of the Bankruptcy Act." Even after the enactment of section 510(c), the vast majority of courts have continued to apply the Mobile Steel test, as recognized by the Supreme Court.

Inequitable conduct under the first prong of the Mobile Steel test is generally defined as either (1) fraud, illegality, or breach of fiduciary duties; (2) undercapitalization; or (3) the claimant's use of the debtor as a mere instrumentality or alter ego. The second requirement is met where the general creditors are less likely to collect their debts as a result of the alleged inequitable conduct. "'If the misconduct results in harm to the entire creditor body, the [trustee] need not identify the injured creditors or quantify their injury, but need only show that the creditors were harmed in some general, concrete manner.'" The third requirement "has been read as a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable."

The purpose of equitable subordination is to undo wrongdoing by an individual creditor in the interest of the other creditors." Nevertheless, many courts view equitable subordination as a "drastic and unusual remedy." Moreover, "the doctrine is remedial, not penal, and should be applied only to the extent necessary to offset specific harm that creditors have suffered on account of the inequitable conduct." As the Bankruptcy Court below itself acknowledged, "the power to subordinate an allowed claim is not boundless and courts cannot use equitable principles to disregard unambiguous statutory language of the Bankruptcy Code."...

Sales and assignments can have very different consequences for the transferee. With respect to assignments, "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." In other words, "an assignee of a claim takes with it whatever limitations

[6] 379 B.R. 425 (SDNY 2007) (footnotes omitted). The case also involved discussion of disallowance which I have omitted from this excerpt. After this decision Springfield asked the Judge to certify the ruling for interlocutory appeal to the Second Circuit, but she denied the request.

it had in the hands of the assignor." These principles are a corollary to the well-established doctrine of nemo dat qui non habet: an assignor cannot give more than he has. By contrast, these assignment law principles do not apply to sales. A purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances. These distinctions apply with the same force to transfers of debt and claims. An assignee of a claim takes no more than the assignor had to give. A purchaser of a claim may take more. Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants. 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...

An exception to assignment law's rule that an assignor cannot give more than he has exists for holders in due course of a negotiable instrument. A holder of a negotiable instrument qualifies as a holder in due course if it takes the instrument: "(a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person." If the holder qualifies as a holder in due course, "he takes the instrument free from (1) all claims to it on the part of any person; and (2) all defenses of any party to the instrument with whom the holder has not dealt [with certain exceptions]."...

It is undisputed that Springfield is not alleged to have itself acted inequitably or received any preference that would subject its claims to equitable subordination .. Nevertheless, the Bankruptcy Court held that claims in the hands of Springfield, the transferee, could be ..subordinated ... based solely on the conduct of Citibank, the transferor.

Enron argues that the Bankruptcy Court's rulings should be affirmed essentially on two grounds. First, Enron argues that the general principle of bankruptcy law that all rights among competing claims to a bankruptcy estate are fixed and determined as of the date of petition, as set forth by the Supreme Court in Sexton v. Dreyfus and United States v. Marxen, applies to equitable subordination ... Thus, Enron argues that because Citibank held the claims on the Petition Date and that Citibank is subject to equitable subordination ... Citibank's claims were forever tainted on the Petition Date. Second, Enron argues that principles of assignment law dictate that a transferee of a claim can have no greater rights than the transferor would have if it still held the claim, and that because the claims in the hands of Citibank were tainted, the transfer of the claim to Springfield cannot cure that taint. Each of Enron's contentions are addressed in turn.

The issue of whether Sexton and Marxen apply to equitable subordination ..of claims begins and ends with the plain language of the statutes. With respect to equitable subordination, the language of section 510(c) reveals that equitable subordination cannot be fixed on the petition date. First, court action is a prerequisite to application of section 510(c). The statute states that "after notice and a hearing, the court may" equitably subordinate a claim. Equitable subordination must be court-ordered, and can be so ordered only after notice and a hearing. Second, equitable subordination is permissive -- not mandatory. The statute makes clear that it is within the discretion of the bankruptcy court, which "may" or may not equitably subordinate a claim under the facts and circumstances of each case. Third, equitable subordination can be based on post-petition inequitable conduct, which obviously cannot be ascertained or fixed on the petition date. Fourth, because Mobile Steel dictates that equitable subordination is not available to creditors who suffered no injury, creditors who acquired their claims post-petition and after the alleged misconduct that forms the basis for the equitable subordination may not be entitled to that remedy. Thus, the circumstances of other creditors can become relevant

post-petition and may alter the availability of equitable subordination....
Accordingly, under the plain language of the statutes, equitable subordination ... cannot be fixed as of the petition date, and thus, the principles of Sexton and Marxen have no application here. Enron's citation to cases holding that statutory priorities become fixed on the petition date and travel with the claim are readily distinguishable. Statutory priorities, such as the wage priority and the United States government priority are capable of being ascertained on the petition date. They are non-discretionary, do not require court action, and are not contingent in any way on the petition date. Thus, while certain priorities become fixed and immutable at the petition date, this is not true for claims of equitable subordination...
The parties do not, and cannot, dispute that the outcome of this case depends on whether the principle that an assignee has no greater rights than its assignor applies to equitable subordination... That issue raises a threshold question of law that the Court must decide: [is] equitable subordination under section 510(c) [an] attribute of a claim or ..personal disabilities of particular claimants. If they are attributes of the claim, they will travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees depends on whether the transfer was by way of a sale or assignment. As discussed below, I find that equitable subordination .. [is a] personal disabilit[y] that do[es] not inhere in the claim. Thus, unless there was a pure assignment (or other basis for the transferee to step in the shoes of the transferor), as opposed to a sale of the claim, the claim in the hands of the transferee is not subject to equitable subordination... based solely on the conduct of the transferor.
1. Equitable Subordination Is a Personal Disability
The issue of whether equitable subordination under section 510(c) travels with the claim and can be applied to a transferee based solely on the conduct of a transferor is a matter of statutory interpretation. Both parties concede that there is no case directly on point. The Bankruptcy Court below was the first court to address the question, and this Court conducts a de novo review of that decision.
Enron stresses a plain language approach to section 510(c), arguing that the statute's reference to subordination of "an allowed claim" demonstrates that equitable subordination becomes an attribute of that claim. The phrase cited by Enron, however, cannot be read in a vacuum. The statute expressly invokes "principles of equitable subordination," which indisputably was intended to incorporate the doctrine as developed by the courts. Thus, I turn to the legislative history and case law to determine whether the legislative intent was to create a characteristic of a claim or rather a personal disability of claimants.
The legislative history and case law both demonstrate that Congress intended to create a personal disability. The legislative history's various references to the requirement of misconduct on the part of the "holder" of the claim demonstrate that Congress intended equitable subordination under section 510(c) to be specific to the individual who acted inequitably. For example, the legislative history states that "[t]o date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor." In fact, Congress specifically rejected a broader wording of the statute that was proposed by the House of Representatives, which provided for subordination "on equitable grounds." The enacted version actually limits the scope of equitable subordination.
Moreover, at the time of the enactment of section 510(c), courts routinely required misconduct

on the part of the creditor asserting the claim before the court would equitably subordinate a claim. Indeed, as already mentioned above, Enron can point to no case, let alone a case pre-enactment, that applied equitable subordination to a transferee of a claim based on the conduct of the transferor. In light of the legislative history's references to inequitable conduct on the part of the holder of the claim, and the lack of any case law existing at the time of enactment that applied equitable subordination absent misconduct on the part of the holder, I find that Congress did not intend section 510(c) to be applied to a transferee of a claim -- who has not acted inequitably -- merely because that claim was transferred, directly or indirectly, by a bad actor.

This result is further supported by the case law following the enactment of section 510(c). Courts consistently have focused on the claimant, rather than the claim, for purposes of applying equitable subordination. For example, the Second Circuit has stated that "equitable subordination is appropriate, inter alia, when the subordinated claimant has engaged in inequitable conduct that injures competing claimants." The Second Circuit thus recognized that the appropriate focus is on the claimant, not the claim. Indeed, one of the Bankruptcy Court's other holdings in the Subordination Order, which is not being appealed, is that a creditor's inequitable conduct can result in equitable subordination of any or all of that creditor's claims, as opposed to only those claims related to the misconduct. Application of equitable subordination to unrelated claims based solely on the fact that they are held by a bad actor demonstrates that the proper focus is on the claimant personally, not the claim.

In fact, one of the cases Enron relies upon as the champion of its cause, In re Multiponics, Inc., actually supports the conclusion that equitable subordination focuses on the holder of the claim rather than the transferor. In Multiponics, the claimant had acquired its claim from two innocent banks. An insider of the claimant had acted inequitably. The district court had found that the claimant was the alter ego of the insider and thus the court imputed the bad acts of the insider to the claimant and equitably subordinated the claim. The circuit court reversed the district court's finding that the claimant was the alter ego of the insider, and thus held that the claim in the hands of the claimant should not have been subordinated. Thus, the holding of the Fifth Circuit comports with this Court's reading of the statute, namely that the focus of section 510(c) is on the claimant, not the claim.

The Bankruptcy Court placed heavy reliance on Goldie v. Cox and general principles of assignment law to support its holding. Reliance on Goldie, however, is misplaced for two reasons. First, Goldie stands for the general proposition that an assignee takes a claim subject to all defenses that the obligor has against the assignor. Equitable subordination is a remedy that belongs to the creditors -- not the debtor. Second, the Bankruptcy Court assumed assignment law's application without deciding whether equitable subordination was an attribute of the claim or a personal disability.

Several other cases cited by Enron support this Court's holding. The cases relied upon by Enron in which courts have applied equitable subordination to a party based on the conduct of a third party are cases where the claim holder has stepped into the shoes of the third party bad actor. For example, in In re 604 Columbus Avenue Realty Trust, the court held that the Federal Deposit Insurance Corporation (the "FDIC"), acting as receiver, steps in the shoes of the failed bank for purposes of equitable subordination. But the court expressly acknowledged that the receivership is unique, and that the FDIC in its corporate capacity purchasing the claim does not step in the shoes of the seller and is protected from application of equitable subordination.

The Bankruptcy Court expressly extended its holding to all transfers of bankruptcy claims. By doing so, it ignored the distinction between assignments and sales and never addressed whether equitable subordination travels with the claim or is a personal disability. Where a claimant has purchased its claim, as opposed to receiving it by assignment, operation of law, or subrogation, assignment law principles have no application with respect to personal disabilities of claimants. Thus, purchasers are protected from being subject to the personal disabilities of their sellers.

The distinction is particularly imperative in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferee up the line) has acted inequitably or received a preference. No amount of due diligence on their part will reveal that information, and it is unclear how the market would price such unknowable risk. Parties to true assignments, by contrast, can easily contract around the risk of equitable subordination ... by entering into indemnity agreements to protect the assignee. This is not to say that every purchaser of a claim will be automatically exempt from equitable subordination. This Court's analysis would not apply to bad faith purchasers. Indeed, purchasers of claims with actual notice of the inequitable conduct of the seller may be subject to equitable subordination based on their own misconduct.

Nor does this Court mean to imply that every assignee will automatically be subject to equitable subordination if the assignor has acted inequitably. For example, the assignee may qualify as a holder in due course and thus take the claim free from all defenses of any party to the instrument with whom the holder has not dealt. In addition, the doctrine of third party latent equities may apply as an exception the assignment law's application in certain cases, depending on which state law governs the assignment contract.

The case illustrates a tension between the policies underlying bankruptcy law (equality of distribution) and recognition of the rights of a good faith purchaser under state law.

3. LOAN PARTICIPATIONS

A loan participation agreement typically does not constitute a direct relationship between a borrower and purchasers of loan participations. The Minnesota Supreme Court considered loan participations in **McIntosh County Bank v. Dorsey & Whitney, LLP:**[7]

Respondents McIntosh County Bank, et al. (respondents) purchased participation interests in a loan sold to them by Miller & Schroeder (M & S). Appellant law firm Dorsey & Whitney, LLP, (Dorsey) was hired by M & S to assist in structuring, documenting, and securing the loan. After the loan was unpaid, the respondents filed a legal malpractice suit against Dorsey, alleging that the respondents were the third-party beneficiaries of the attorney-client relationship between Dorsey and M & S, because M & S intended Dorsey's services in documenting the loan transaction to benefit the banks that purchased participation interests in the loan. The district court determined that the respondents were neither clients nor third-party beneficiaries, and

[7] 745 N.W.2d 538 (2008).

granted summary judgment to Dorsey. The court of appeals reversed the district court's grant of summary judgment on implied contract and third-party beneficiary theories of standing, holding that the district court failed to apply the appropriate test to determine whether Dorsey owed a duty to the respondents as third-party beneficiaries. We reverse the court of appeals and affirm the district court's grant of summary judgment.

The St. Regis Mohawk Tribe (Tribe) and President R.C.-St. Regis Management Company (President) entered into a Fourth Amended and Restated Management Agreement (Management Agreement)... The Management Agreement required President to pay all development expenses for a casino to be opened on the Tribe's land and to manage the casino once it was built. The Tribe was required to repay the development expenses to President, as well as fees for the management services. The amounts due to President at any particular time were determined with reference to the casino's revenues. Management contracts and collateral agreements between Indian tribes and casino management companies are subject to approval by the National Indian Gaming Commission (NIGC)...The Management Agreement received NIGC approval.

M & S agreed in 1998 to obtain financing for President to fund construction and furnishing of the Tribe's casino. M & S negotiated two separate loans (St. Regis loans) to President, the first for $ 8,624,000 and the second for $ 3,492,000. The loans were to be secured by President's interest in revenues from the casino. Before closing a loan, M & S typically obtained commitments from banks to purchase participation interests after closing. M & S's business model called for it to sell 100% of the interest in its loans within one week of closing, and to retain loan servicing. 32 banks (Participants) purchased participation interests in the St. Regis loans. Respondents are 31 of the banks (Bank Participants) and Marshall Investments Corporation, which later entered into subservicing agreements with M & S.

Before signing a Participation Agreement with M & S, each Participant was given a closing book, which included copies of the loan documentation and a template of the Participation Agreement. In the Participation Agreement, M & S was called the "Lender," and the parties defined their relationship as that of "a seller and purchaser of a property interest." The parties agreed that M & S was the "nominal payee" and "nominal secured party," and that it was "to generally act as agent for all the Participants in the holding and disposition of the Collateral." The Participants acknowledged that they purchased their interest "based upon Participant's own independent examination and evaluation of the Loan transaction and the information furnished with respect to Borrower and without any representations or warranties from Lender as to “the value and security of the Collateral." The Lender was not to be "responsible for any negligence or misconduct on the part of any “attorney,” provided that the Lender shall use reasonable care in the selection of such person or firm."

In late 1998, M & S retained Dorsey, the appellant here, to assist in structuring, documenting, and securing the loan. Dorsey had previously handled over thirty loans originated by M & S and was familiar with the business model used by M & S and with the Participation Agreement. M & S and Dorsey did not have a written retainer agreement about the St. Regis representation.

One of the loan documents drafted by Dorsey attorney Paula Rindels (Rindels) was a Notice and Acknowledgment of Pledge (Pledge Agreement), signed by President, the Tribe, and M & S. The Pledge Agreement's enforceability was critical to securing the St. Regis loans. There was no other guarantee. In this document, the Tribe acknowledged that President had pledged to M & S, as security for the St. Regis loans, the amounts payable by the Tribe to President under the Management Agreement.

The Tribe's signature on the Pledge Agreement was authorized by a Tribal Council Resolution, which conditioned its execution of the Pledge Agreement on inclusion of certain changes to the Management Agreement. One of the changes desired by both President and Tribe was an increased cap on development expenses. A cap increase is a change requiring NIGC approval. The Tribe and President amended the Management Agreement on February 11, 1999, increased the cap, and included the changes in the Pledge Agreement. The amendment to the Management Agreement (Amendment) was submitted to the NIGC for approval. Management contracts or other agreements requiring NIGC approval but not receiving it are void...

During Dorsey's preparation of loan documentation for the St. Regis loans, a question arose as to whether NIGC approval of the Pledge Agreement was required. Dorsey submitted the Pledge Agreement to the NIGC for a determination on this issue.

On February 16, 1999, the NIGC notified President and the Tribe that it would need additional time to complete its review of the Amendment. President wished to close the St. Regis loans in mid-February, so that the casino's grand opening could occur as planned in April. Dorsey advised M & S that NIGC approval was not required for the Pledge Agreement. There are conflicting facts as to whether Dorsey informed M & S of the risk involved in closing without obtaining NIGC approval or an NIGC determination that no approval was required. M & S employee Steven Erickson, manager of the Native American financing gaming group, asserts that Dorsey did not advise M & S of the risk of proceeding without an NIGC determination. Rindels asserts that she discussed the risk with at least one M & S representative prior to closing.

M & S had initially advised Participants that it would not close the loans without NIGC approval. When it became clear that NIGC approval could not be obtained in time to close the loans in February, M & S wrote to the Participants, recommending that the St. Regis loans be closed despite lack of NIGC approval, and requesting that the Participants vote on the matter. The Participants voted to close the loans. Rindels was aware that M & S had sent this letter, although no Dorsey attorney drafted the letter and the letter included no reference to Dorsey. Erickson asserted that M & S would not have closed the loans if it had known of the risk of closing without NIGC approval. M & S continued to request proof of NIGC approval after the loans closed.

The Bank Participants were aware that M & S had retained Dorsey. There are conflicting facts regarding whether the purpose of the attorney-client relationship between M & S and Dorsey was to benefit the Bank Participants. Erickson said on one hand that M & S retained Dorsey for the benefit of all the lenders, including the Bank Participants, and on the other that Dorsey was retained to represent only M & S. M & S attorney Mary Jo Brenden consulted with Dorsey attorneys about revisions needed in the Participation Agreement to protect the Participants, but Dorsey did not draft the template Participation Agreement. There were no communications between the Bank Participants and Dorsey regarding the St. Regis loan documentation and closing. Dorsey denied being aware of the identities of the actual Bank Participants prior to their purchase of participation interest in the loan and denies that its work for M & S was intended to directly benefit the Bank Participants.

The St. Regis loans were closed on February 24, 1999. By March 1, 1999, M & S had sold most of the participation interest in the loans. The casino opened in April of 1999. Revenue was well below projections, and by February 2000 President had defaulted on the St. Regis loans. Dorsey, M & S, and some Participants attempted to negotiate a resolution to the problem of the loan default with President and the Tribe in the fall of 2000. At an October 3 meeting, a Tribe

representative expressed the opinion that the Pledge Agreement was unenforceable and void because it had not received NIGC approval.
M & S sued President in U.S. District Court for collection of the unpaid loan amounts, and in April 2002 judgment was entered for M & S in the amount of $ 15,625,528.16. The judgment has not been collected because President has no assets. M & S filed for Chapter 7 bankruptcy relief in January 2002. The Bank Participants and President, in separate actions in New York state courts, attempted to collect from the Tribe, which itself filed a qui tam action 3 against President and respondents, seeking a declaration that the Pledge Agreement was void and unenforceable. On April 11, 2005, the respondents, participant Bremer Business Finance Corporation (Bremer), and the Tribe reached a settlement in which the Tribe paid Bremer and the respondents for their interest in the President judgment.
Having exhausted their efforts to collect on the loans against President and the Tribe, the Bank Participants joined with the M & S bankruptcy trustee and Marshall to bring malpractice claims against Dorsey in bankruptcy court. At issue was Dorsey's advice to close the loan without waiting for NIGC approval or an NIGC determination that approval was not required. The bankruptcy court dismissed 28 banks' claims for lack of subject matter jurisdiction, abstained from hearing the remaining participants' claims, and denied Dorsey's motion for summary Judgment. Bremer's malpractice action against Dorsey went to trial in bankruptcy court, which recommended a finding that an attorney-client relationship existed between Dorsey and Bremer.... On April 6, 2007, the U.S. District Court found on de novo review that Bremer's attorney-client relationship with Dorsey began only in June 2000, and that Bremer was not a third-party beneficiary at the time the loans were closed by M & S in early 1999.
Respondents brought this malpractice action in Hennepin County District Court, with claims of professional negligence/malpractice on a third-party beneficiary theory, negligent misrepresentation, breach of contract, and breach of fiduciary duty. The breach of fiduciary duty claim was voluntarily dismissed. Dorsey moved for summary judgment on the remaining claims. The district court granted summary judgment on January 17, 2006, concluding (1) that there was no genuine issue of material fact regarding the existence of an express or implied contract for legal services between the respondents and Dorsey; (2) that the respondents' reliance on information received from M & S was insufficient to create an attorney-client relationship with Dorsey under a tort theory; (3) that under the third-party beneficiary theory there was no genuine issue of material fact about whether the respondents were the sole and direct intended beneficiaries of Dorsey's representation of M & S; and (4) that on the negligent misrepresentation claim, in which liability to a nonclient arises only if the attorney has acted with fraud, malice, or committed another intentional tort, no genuine issue of material fact existed about whether Dorsey acted in such a way as to incur liability.
The court of appeals affirmed summary judgment on the negligent misrepresentation claim, on a contract-assignment theory, and on the tort theory of an attorney-client relationship, but reversed on the implied contract and third-party beneficiary theories.... The court of appeals concluded that there were genuine issues of material fact regarding whether the respondents were third-party beneficiaries, and that the district court erred in its application of the law when it did not use the correct test to make that determination... On the implied contract theory, the court of appeals concluded that there were genuine issues of material fact regarding M & S's and Dorsey's understanding of the scope of the representation... Dorsey petitioned for review.
...The first issue is whether the respondents have standing to sue Dorsey for legal malpractice as a third-party beneficiary of the attorney-client relationship between M & S and Dorsey. The

general rule in legal malpractice is that, in the absence of fraud or another improper motive, an attorney is liable for professional negligence only to a person with whom he has an attorney-client relationship... If an attorney were to owe a duty to a nonclient, it could result in potential ethical conflicts for the attorney and compromise the attorney-client relationship, with its attendant duties of confidentiality, loyalty, and care. In L&H Airco v. Rapistan Corp., we held that absent extraordinary and extreme circumstances involving actual fraud, an attorney may not be held liable in damages to his party-opponent... We stated that such liability "would undermine the attorney's duty to zealously represent the client and resolve all doubts in favor of the client." ... "It would also undermine the trust between the attorney and client, which is an essential element of the relationship." ..

We have recognized an exception to the general rule of privity in two attorney malpractice cases: Marker, .. in which we adopted a balancing test from the California case of Lucas v. Hamm..and Admiral Merchants Motor Freight, Inc. v. O'Connor & Hannan.... Dorsey argues that Marker and Admiral Merchants establish a threshold requirement that a nonclient be a "direct and intended beneficiary" of the attorney's services; if the nonclient is not the direct and intended beneficiary, the so-called Lucas factors are inapplicable. Dorsey asserts that the Lucas factors are applied only to determine the extent of the duty owed, not whether a duty is owed in the first instance. The respondents argue that Marker adopted the Lucas factors as the primary test to determine whether a plaintiff is a third-party beneficiary of an attorney's services, with standing to sue the attorney. The court of appeals agreed with the respondents, concluding that the district court erred when it did not apply the Lucas factors to determine whether the respondents had standing to sue...The court of appeals noted that "Minnesota courts have been inconsistent in defining the proper role of the Lucas factors."..

We reaffirm the rule of law announced in Marker that in order for a third party to proceed in a legal malpractice action, that party must be a direct and intended beneficiary of the attorney's services. To determine the extent of the duty owed to the direct and intended beneficiary of the attorney's services, we will consider the so-called Lucas factors. Given the confusion about the meaning of the Marker decision, we think it prudent at this time to elaborate further on the meaning of "a direct and intended beneficiary."

We turn first to the meaning of a "direct" beneficiary. A party is a direct beneficiary of a transaction if the transaction has as a central purpose an effect on the third party and the effect is intended as a purpose of the transaction.... (concluding that the law imposes potential liability beyond the parties to the contract when the third party is actually at the heart of the contract). In the words of Justice Cardozo, writing for the court in Glanzer, the benefit to the third party must be "the end and aim of the transaction" before the beneficiary may be called direct.... Requiring that the transaction directly benefit the third party properly serves to prevent nonclients who receive incidental benefits from the representation, or who only receive downstream benefits, from holding the attorney liable.

We turn next to the question of who must be aware of the "intended" beneficiary--the client or the attorney? We described all of the cases we relied on in Marker as "situations in which the attorney by his actions produced an instrument that failed to carry out the testamentary intent of the testator."... The testator intended to make a gift to someone, to make someone a beneficiary of his will, and the negligence of the attorney led to that person not receiving the gift. Clearly, the testator-client's intent is crucial. However, the "third-party beneficiary" exception as developed in the will context also implies an attorney's awareness that the client's intent is to make someone a beneficiary of his will....

We conclude that the attorney must be aware of the client's intent to benefit the third party in order for the exception to be applicable. Such a requirement is in keeping with the fiduciary and ethical duties attorneys owe their clients. Imposing on attorneys a duty toward beneficiaries of whom they are unaware would risk dampening their zealous advocacy on behalf of clients, for fear of harming a third party to whom a duty might later be found to be owed.

Applying these principles to this case, we conclude that the respondents were not direct and intended beneficiaries of the attorney-client relationship between M & S and Dorsey. This case is far from the will-drafting context in which the third-party beneficiary theory was first developed. Bearing in mind that on this motion for summary judgment we must view the evidence in the light most favorable to the nonmoving party, we conclude that the respondents have not produced evidence that a central purpose of the attorney-client relationship between M & S and Dorsey was to affect the respondents or that the purpose of the transaction was to benefit the respondents. The purpose of the transaction was to close the St. Regis loans. The respondents had no direct communication with Dorsey. They acknowledged in their Participation Agreements that they purchased participations in reliance not on M & S but on their own independent evaluation of the loans. The Bank Participants have shown that Dorsey was aware of M & S's participation model. The depositions and affidavits of Erickson say that M & S expected Dorsey's work to benefit the Bank Participants, but that only M & S was Dorsey's client. Even if M & S did intend Dorsey's work to benefit the purchasers of participations, this would not be enough to impose liability under the test we have clarified above; Dorsey would need to be aware of that intent.

The record does not indicate that Dorsey was aware of that intent. Mary Jo Brenden stated she expected Dorsey would provide advice to benefit both M & S and the Participants, but she points to no conversation in which she expressed that to Dorsey. Although she asked Dorsey for advice in revising the participation agreement, and the changes were for the protection of the Participants, there is no indication that this advice was more than an incidental part of Dorsey's representation. The names of the Bank Participants were not included in any of the instruments Dorsey drafted. No Bank Participant met with Dorsey attorneys prior to or at closing. There was no communication between the Bank Participants and Dorsey before or at closing. The respondents' situation is more analogous to that of the plaintiffs in the California case of Goodman v. Kennedy, whose "only relationship to the proposed transaction was that of parties with whom defendant's clients might negotiate a bargain at arm's length." ... The evidence in the record is not sufficiently probative of a third-party beneficiary relationship to allow reasonable persons to draw different conclusions. Because the respondents are not direct and intended beneficiaries, we do not reach the Lucas factors. We reverse the court of appeals and affirm the district court's grant of summary judgment on this issue..

The second issue is whether an implied contract for legal services existed between the Bank Participants and Dorsey. The court of appeals, pointing to Dorsey's awareness that M & S would sell participation interests in the loan, and to Dorsey's familiarity with similar transactions involving M & S, determined that genuine issues of material fact remained regarding Dorsey's and M & S's understanding of the scope of the representation....

The undisputed facts demonstrate that there was no implied agreement between Dorsey and the respondents. There were no communications between the Bank Participants and Dorsey before closing. There was no notice to Dorsey that it was expected to represent the Bank Participants. Indeed, Dorsey was unable to identify the Bank Participants before closing. Viewing the evidence in the light most favorable to the respondents, the only facts supporting a denial of summary judgment regard understandings between M & S and Dorsey. This evidence is not sufficiently probative of an implied contract to allow reasonable persons to draw different conclusions. The simple fact that the respondents would benefit from Dorsey's services does not impose contractual liability. As a matter of law, there was no implied contract for legal services between Dorsey and the respondents, and summary judgment is appropriate.

Would the purchasers of the loan participations been in a better position if they had bought the loans?

Loan Participation Programs Risk Being Recharacterised

See the discussion in **Re Okura** 249 B.R. 596 (Bankr. SDNY 2000) :

The Law of Participation Agreements
Participation agreements are a form of multiple lender transaction. Multiple lender transactions have been an investment device for more than one hundred years... From the beginning, ownership and control of some single mortgages, known as split mortgages, were in the hands of many as participants. These split mortgages, which came to be known as syndicated loans, were actually joint ventures where each participant received an executed note from the mortgagor... A syndicated mortgage, by virtue of its individual mortgage note, provides each lender recourse against the borrower...
Modern multiple lending agreements are often classified as either participation agreements (true participations), interbank loans, or syndication agreements... The most common multiple lending agreement is the loan participation which involves two independent, bilateral relationships: the first between the borrower and the lead bank and the second between the lead bank and the participants... As a general rule, the participants do not have privity of contract with the underlying borrower... In an interbank loan, one bank lends the funds of another bank which, in turn, lends to the borrower. In a syndication agreement, the banks jointly lend money...
One aspect of loan participations that makes them attractive is the delegation of administrative tasks, like origination costs and servicing responsibilities to a lead lender... Participants are able to invest in loans offering good returns without having to invest in the administrative staff required to originate them on their own...
Other reasons that banks enter into participation agreements include: diversifying lending portfolios by region and property type.. spreading the risk associated with extending credit... achieving a higher interest rate on a loan than would be typically available if the participant had directly extended the loan to the borrower ...and avoiding the lending limits imposed on banks under federal banking law....

D. Persuasive Authority
The courts are generally in agreement that a transfer of an undivided interest and participation in the context of a true participation does not allow the participant to assert a claim against the borrower.....
I found two of these cases to be particularly instructive because of their factual similarities to the matter before me. See In re Yale Express Sys., Inc... and Mason & Dixon Lines, Inc. v. First

Nat'l Bank of Boston...
In In re Yale Express Systems, the debtor-borrower borrowed money from First National City Bank ("FNCB"). FNCB, in turn, sold an "undivided 40% participation" in the loan, pursuant to a participation agreement, to Marine Midland Trust Company of New York ("Marine")... The participation agreement provided that FNCB retained the sole right to agree to changes in the terms of the credit agreement with the debtor, except for changes in the terms of payment of principal, interest, premiums or fees... Also, FNCB retained the sole discretion to exercise any remedy in connection with a default...
Marine had a longstanding relationship with the debtor including a separate account it maintained with Marine.. In fact, the Yale Express court noted that Marine's longstanding relationship with the debtor undoubtedly served as an inducement for it to become a participant in the loan to Yale Express... After the debtor defaulted on the loan to FNCB and filed for bankruptcy, Marine sought to setoff the money it held on deposit against the money the debtor owed to FNCB (and indirectly Marine) under the loan.
The District Court denied Marine's application because it had no direct creditor relationship with the debtor under the participation agreement.. "I find that the provisions of the participation agreement between Marine and FNCB, particularly when read in the light of various agreements between Yale and FNCB negate the existence of any such creditor status as Marine now claims." .. The court reasoned that under the participation agreement Marine advanced money only to FNCB and that Marine's right to repayment would arise only upon receipt by FNCB of payment from Yale.. The court also relied on the fact that FNCB retained the right to modify the loan agreement and to enforce any rights under the loan agreement in the event of a default..
The Yale Express case is almost on all fours with this case. Here, as in Yale Express, BTM had a long-standing credit relationship with the Debtor which undoubtedly influenced its decision to become a participant in the LCA. Furthermore, BTM advanced money only to Fuji and, under the Participation Agreement, BTM's right to repayment arises only upon Fuji's receipt of payment from the Debtor. Lastly, under the Participation Agreement, Fuji retained the sole right to modify the LCA (except for certain limitations similar to those imposed upon FNCB under its participation agreement with Marine) and to enforce any rights or remedies in the event of a default by the Debtor. Following Yale Express, I conclude that BTM is not a creditor of the Debtor.
Mason Dixon Lines Inc. v. First National Bank of Boston is analogous to this case. In Mason Dixon, the debtor borrowed money from First National Bank of Boston ("Bank of Boston")... On the same day that the debtor entered into the loan agreement with Bank of Boston, Bank of Boston entered into a participation agreement with Third National Bank of Nashville, Tennessee ("Third National").. The participation agreement provided that Bank of Boston would credit Third National with an undivided 50% interest in the loan..
Subsequently, the debtor filed for bankruptcy and Bank of Boston filed a proof of claim for the entire amount of the indebtedness due under the loan agreement.. During the course of the case, the debtor continued to make payments on the loan to Bank of Boston.. After two years of making payments, the debtor filed an objection to Bank of Boston's claim on the ground that Bank of Boston could properly claim only the percentage of the loan that has not been participated by Third National.. The debtor argued that the remainder of the loan was owed to Third National instead of Bank of Boston.. The Bankruptcy Court held that Bank of Boston's creditor status was not altered by the participation agreement with Third National and that Bank

of Boston was entitled to file a proof of claim for the entire amount.. The Bankruptcy Court also found the debtor's motion so lacking in merit that it warranted the imposition of sanctions..

On appeal, the District Court affirmed the Bankruptcy Court.. Holding, in part, "that participants are not generally creditors of the debtor. Accordingly, any collections and filing of proofs of claim in bankruptcy should be made by the party to whom the underlying obligation is owed, namely the lead lender." ..

BTM attempts to muddy the otherwise clear picture that emerges from examining the authority in other jurisdictions by citing to a series of dissimilar cases which it contends stand for propositions in support of its case.

In re Drexel Burnham Lambert Group Inc....does not support the argument that BTM has a claim against the Debtor. In Drexel Burnham, the loan arrangement was not a true participation. Rather it was a joint loan where certain interests were assigned to "Group Members."... These Group Members made individual advances, charged different interest rates and their interests were evidenced by individualized notes.. The loan agreement also provided that the borrower's "obligation to repay principal and to pay interest ran directly to each lender." ..

The loan agreement in Drexel is different from the one before me. That agreement had all of the hallmarks of a joint loan with, unlike in a participation agreement, a direct debtor-creditor relationship established between the borrower and each of the lenders. In fact, the Drexel court specifically noted that "[these features] underscore that this agreement far exceeds the usual single note joint loan nature of loan participation agreements." .. Since this case is neither factually nor legally similar to the one before me, it is unpersuasive...

Savings Bank of Rockland County v. F.D.I.C. is similarly unpersuasive... In that case, the participant, The Savings Bank of Rockland County ("Rockand"), sought to ascertain its rights under a particular participation agreement vis-a-vis the lead bank, Peoples National Bank of Rockland County ("Peoples"). In addition to this very different legal issue, the facts facing the court in Rockland are also distinguishable.

Peoples originally held approximately 164 consumer loans with a face value of about $ 4 million... Peoples soon realized that it was chronically undercapitalized and sought to sell the loans.. It sold an 80 percent interest to Rockland.. Peoples guaranteed Rockland's interest in the event of default and waived its own ability to "waive, modify, release or consent to postponement of any borrower's obligation" without the consent of Rockland.. Rockland also received an interest rate higher than the underlying loan.. Peoples then went into receivership and the receiver, the F.D.I.C., "disaffirmed" the participation agreement and refused to forward any of the $ 1 million it received as payments under the loans.. The question for the court was whether Rockland had an ownership interest in those proceeds. The court found that it did..

The question before me, however, is not whether the participant has an ownership interest in loan proceeds received by the lead lender, but whether a participant has a right to assert a claim against a debtor-borrower in bankruptcy.. The agreement before the court in Rockland, moreover, is very different from a typical true participation or the Participation Agreement. For example, the lead lender guaranteed Rockland's interest in the event of default; Peoples did not retain the right to proceed against the borrower; Rockland was promised a greater interest rate than the underlying loan agreement provided, and the overall lead position Rockland took in the loan. None of these facts are present in this case. Significantly, even in this case, Peoples, not Rockland, collected from the borrower. Since the Rockland decision is both factually and legally distinguishable from the matter facing me, I find it unpersuasive...

E. Status as Tenants in Common

BTM next argues that, under New York law, the Undivided Interest and Participation Clause should be construed to grant BTM the rights of a tenant in common with Fuji in the LCA. In order for a tenancy in common to exist "two or more persons [must] each own and possess an undivided interest in property, real or personal."... A tenancy in common, therefore, is created when a holder of an ownership interest in property assigns part of that interest to another party. Here, since only Fuji is a party to the LCA, the question is whether the Participation Agreement affected a partial assignment of Fuji's interest to BTM. Under New York law that question must be answered in the negative.

Notably, BTM cites to no case law in which a participation agreement, many of which contain clauses similar to the Undivided Interest and Participation Clause, is construed in the manner in which BTM asks me to construe this agreement. The reason is clear. The rights created by a tenancy in common are very different from those created by a participation agreement. "Under New York law, an assignment occurs only where the assignor retains no control over the funds, no authority to collect and no power to revoke."... Here, none of these factors are present. Fuji, not BTM, retains almost complete control over the funds and the collateral. In addition, Fuji is given the sole right to collect monies under the LCA or to enforce rights in the event of a default. Furthermore, under the Participation Agreement, BTM does not have the right to assign its interest absent written consent from Fuji... An assignment at law contemplates 'a completed transfer of the entire interest of the assignor in the particular subject of the assignment, whereby the assignor is divested of all control over the thing assigned.'"... Since BTM has none of the ownership rights typically associated with a tenant in common, I find this argument lacking in merit.

F. Effect of Banking Regulations

BTM also maintains that because the portion of a lead bank's loan which is sold as a participation interest is not included in the lead bank's calculation of outstanding credit, the participated portion should be viewed for bankruptcy purposes as sold and assigned. See 12 C.F.R. § 32.2(j)(2)(iv) (1998). This regulation, which was established by the Comptroller of the Currency, is meant to ensure the solvency of banks by preventing banks from making excessive loans... Since participants adopt a proportionate risk of loss on an underlying loan to the extent of the participation, it is sensible that the participation is not included in the lead bank's books as an outstanding loan.

Despite the fact that participations are listed a certain way on lead banks' books, I disagree with BTM that this regulation has any relevance to the matter before me. In this case, the parties contractually agreed to limit BTM's rights and obligations under the Participation Agreement. They could have entered into a different type of arrangement with different rights and responsibilities, but they chose this one. Thus, I reject this argument as irrelevant.

G. The Extrinsic Evidence

Lastly, BTM claims that by viewing the "unique circumstances" of this transaction together, the court should find that the parties intended for BTM to have a direct claim against the Debtor. This broader perspective, it argues, can only be understood by reading the Participation Agreement in conjunction with the Extrinsic Materials.

As I discussed above, the Participation Agreement is unambiguous. Once that determination is made, the rule in New York is that parol evidence is not admissible to establish a contract's meaning... Here, the agreement is unambiguous and, as a result, I will not look beyond the four corners of the Participation Agreement to construe its meaning.

Even if I did consider the evidence offered by BTM, it does not show that the parties intended that BTM have a direct claim against the Debtor as to this participation agreement. The documents offered by BTM include an affidavit of Akira Takeuchi, Vice President of BTM, a letter from Okura-Japan to BTM and an "Agreement for Credit Instruction".. Mr. Takeuchi asserts that the participation agreement should not be considered an independent contract but instead should be considered an integral part of a longstanding credit relationship between BTM and the Debtor's parent, Okura-Japan. According to Takeuchi, BTM and the Debtor have been doing business together since Okura-Japan's inception. This relationship has included negotiations between BTM, the Debtor and Okura-Japan regarding credit extensions, the submission of credit applications to BTM by Okura-Japan on behalf of the Debtor and an express guarantee of all of the Debtor's obligations, including those under the Participation Agreement.

None of these assertions, even if relevant, defeat the plain wording of the Participation Agreement and the two documents to which it refers, the LCA and the Participation Certificate. The fact that BTM had a longstanding credit relationship directly with the Debtor or with its parent does not mean that at any particular time they were not free to change this relationship or enter into a contract with another party, like Fuji, in order to do business indirectly with the Debtor. BTM and the Debtor, as sophisticated business entities, could have achieved a direct lending relationship by the terms of the agreement, but did not...Considering the Extrinsic Materials, therefore, would not alter the plain meaning of the Participation Agreement or BTM's status as a non-creditor in this proceeding as to the Debtor's indebtedness under the LCA.

VI. CONCLUSION

BTM's opposition to the Trustee's motion can be aptly summarized as a blunderbuss defense. Instead of identifying a single legal theory upon which to rely, BTM attempts to defeat the Trustee's motion by making a series of unconnected, non-compelling arguments. Apparently, BTM was hoping that by creating a veritable cloud of arguments and issues, the underlying weakness of its position would not be exposed. Once the essence of BTM's position was identified, and its spurious arguments cleared away, it was apparent that its position is untenable. Furthermore, given the sophisticated nature of the parties, it is not unfair, from a policy standpoint, to strictly construe the terms of a participation agreement and hold the parties to the bargain they struck...

Interests in Loans Risk Being Treated as Securities under the Federal Securities Laws

If an interest in a loan is a security it will need to be registered under the Securities Act 1933 unless an exemption from registration applies. If an interest in a loan is a security the anti-fraud rules in the federal securities statutes will also apply.

Registration involves expense. Alan Palmiter says:

The costs of mandatory disclosure in securities offerings, borne ultimately by investors, are imposing. There are direct costs: the issuer pays for assembling mandatory information, retaining accountants to certify financial information, and hiring inside and outside lawyers to format and present it. There are indirect opportunity costs: compliance with mandatory disclosure diverts management attention from the issuer's business; protracted regulatory approval, typically in excess of two months, delays the issuer's access to capital and increases its capital costs. Regulatory compliance imposes competitive costs: public disclosure, ostensibly meant for investors, can harm the issuer's business when used by competitors, particularly privately-held competitors that do not make reciprocal public disclosures. And there are liability costs: public offerings expose issuers (and their shareholders) to fraud litigation that overreacts to misinformation, thus chilling public offerings and the beneficial disclosure of "soft" and other nontestable information; underwriters, accountants, and other participants pass on their liability costs to the issuer in the form of higher fees; mandated issuer warranties and "due diligence" verification in public offerings further chills the production of information.[8]

A security is:

any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[9]

Interests in loans are securities if they fall under the definition of a “note”. The seminal case on the interpretation of the word “note” is *Reves* v *Ernst & Young*, 494 U.S. 56 (1990). The following case discusses the application of Reves to promissory notes issued by a broker.

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[8] Alan R Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 12.

[9] 15 U.S.C. § 78c(a)(10)

Stoiber v SEC[10]

Judge Wald: Petitioner Gerald Stoiber is an Illinois broker associated with American Investment Services, Inc. ("AIS"). AIS is a member of the National Association of Securities Dealers, Inc. ("NASD"), a self-regulatory organization in the securities field. Stoiber borrowed a total of $495,000 from his customers, gave the lenders promissory notes in exchange, and used most of the money to invest in commodities. The NASD filed disciplinary charges against him, asserting that he violated the NASD Rules of Fair Practice by selling securities (the notes) without giving AIS prior written notice. Stoiber was sanctioned by the NASD and appealed to the ...SEC.. which affirmed the sanctions... The SEC denied a request for reconsideration...

A. Whether the Promissory Notes are Securities
Stoiber argues that the Commission erred in determining that the promissory notes he executed in return for the funds provided by his customers are properly classified as securities. If the notes are not securities, he could not be held to have violated Section 40.
The definition of "security" in section 3(a)(10) of the Securities Exchange Act of 1934, the source of the SEC's authority in this matter, includes a long list of financial instruments, beginning with "any note." Although courts initially interpreted "any note" literally ...an inquiry into whether a particular note is a security has become much more demanding under the test articulated by the Supreme Court in Reves v. Ernst & Young... The Court stated there that "the phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts... Congress' purpose "was to regulate investments, in whatever form they are made and by whatever name they are called."..

Under the Reves "family resemblance" test, every note is first presumed to be a security but the presumption may fall away under either step of a two-tiered analysis... In the first step the notes under review are compared to several types of notes that the Court specifically said are not securities. Those are
the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, [ ] a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)[, and] ... notes evidencing loans by commercial banks for current operations...
The comparison between the note in question and the excluded notes is to be made by considering four factors: (1) "the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]," (2) "the 'plan of distribution' of the instrument," (3) "the reasonable expectations of the investing public," and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.".... The note is not a security if this four-factor comparison reveals a "strong resemblance" to one of the enumerated types of notes... If a

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[10] 161 F.3d 745 (DC Cir.1998). And see also McNabb v SEC 298 F.3d 1126 (9th Cir. 2002) (promissory notes as securities.)

strong resemblance is not found, the court invokes the second step of the analysis--"the decision whether another category should be added...." .. This decision "is to be made by examining the same [four] factors.".. Whether a note is a security is a question of law, so the court applies this test de novo...

1. The First Reves Factor--Motivation

Reves explains the first factor as follows:

First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."...

We have little trouble concluding that Stoiber's main purpose for using the notes points in the direction of their being securities. All but $ 50,000 of the $ 495,000 raised from his customers was used for commodities trading in his personal account. Moreover, in reaffirmation statements signed when they declined Stoiber's rescission offers, the customers acknowledged that they knew at the time of the transactions that most of the money would be used for such trading. We think trading in commodities clearly falls under the "financing substantial investments" language in Reves.

Stoiber predictably disagrees. He argues that he was in the business of selling commodities and that he used the money to purchase inventory which he then attempted to resell at a profit. This he terms a commercial, not an investment purpose. Stoiber's regular business, however, was buying and selling on behalf of his customers; his earnings came not from the difference between the purchase and sale prices of the securities he traded but from commissions. Stoiber's trading in commodities was not part of his brokerage business, and so we cannot say that the commodities trading had a commercial purpose related to that business.

But even if we accept the proposition that personal commodities trading was a new business Stoiber planned to operate distinct from his usual brokerage business, use of the note money to buy an inventory of commodities is more akin to "raising money for the general use of a business enterprise" than the specific commercial uses cited in Reves such as remedying a cash flow deficit or purchasing a specific asset. Although the line between commercial and investment uses may not always be sharp, Reves' examples appear to distinguish between funding the enterprise generally and funding a discrete component or department of the enterprise. Because the purchase of commodities for reselling was at the core of Stoiber's "business" of trading in them, his use of the money to buy them is appropriately viewed as a general business use.

We also perceive that Stoiber's customers were primarily motivated by the opportunity to earn a profit on their money. The NASD's investigator interviewed the note holders and testified that "the customers were providing the money because they knew Mr. Stoiber fairly well and trusted him and were interested in receiving a competitive interest rate." ... The rates they received – two points over prime – were described by the SEC, possessed of greater expertise than we, as "favorable."... And the Supreme Court has said a favorable interest rate indicates that profit was the primary goal of the lender... The fact that the rates were fixed and not variable does not suggest otherwise...

Stoiber argues that the customers provided funds because of the personal relationships he had with them. His evidence includes affidavits submitted by the note holders, which state that "I believe Mr. Stoiber is an honest and successful business person, and I believe him to be a good risk to repay me the loan; that is the reason why I loaned him this money." This display of trust, however, does not speak to the note holders' original motivations in making the loans. Rather, it speaks to the information available to them when deciding whether the notes involved a tolerable level of risk. The only evidence in the record that sheds light on the customers' motivations indicates that profit in the form of interest was their primary goal.

There is also a substantial difference between the goals of the parties in this case and those involved when banks provide character loans or commercial loans for current operations--two types of lending evidenced by notes that are not considered securities under Reves, and which Stoiber argues bear a "family resemblance" to his notes. Character loans are generally offered in an attempt to cement or maintain an ongoing commercial relationship with the borrower. A loan for current operations allows the borrower to achieve the commercial goal of continuing to operate a business smoothly during a period when cash inflows and outflows do not match up. These purposes do not characterize the notes here. Unlike with a character loan, the note holders were not trying to satisfy a potential or actual customer. Unlike with a loan for current operations, Stoiber was funding his entire endeavor, not just getting past a cash crunch.

2. The Second Reves Factor--Plan of Distribution

Under the second Reves factor, we examine the plan of distribution of a note "to determine whether it is an instrument in which there is common trading for speculation or investment.".. "The requisite 'common trading' " is established if the instrument is "offered and sold to a broad segment of the public...."..

This factor points in no clear direction in this case. While the terms of the notes do not preclude trading in a secondary market, none have been resold and there is no indication that anyone has considered reselling them. Nor do we think thirteen customers with whom Stoiber had a personal relationship constitute "a broad segment of the public."

On the other hand, Stoiber solicited individuals, not sophisticated institutions. While his solicitations included individual presentations, he offered his customers little detail. These facts suggest common trading... Banco Espanol de Credito v. Security Pac. Nat'l Bank...

3. The Third Reves Factor--Expectations

The Supreme Court described the third factor as follows:

Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction...

Whether notes are reasonably perceived as securities generally turns on whether they are reasonably viewed by purchasers as investments... When a note seller calls a note an investment, in the absence of contrary indications "it would be reasonable for a prospective purchaser to take the [offeror] at its word."..Conversely, when note purchasers are expressly put on notice that a note is not an investment, it is usually reasonable to conclude that the "investing public" would not expect the notes to be securities... Here, there is no indication that Stoiber called the notes investments. Although of questionable value due to their conclusory character, affidavits submitted by the customers stated that the notes were not considered to be

investments. The limited evidence thus suggests that Stoiber's investing public did not reasonably view the notes as securities.
This admission does not, however, add much to the inquiry into whether the promissory notes are securities. The Supreme Court itself described this factor as a one-way ratchet... It allows notes that would not be deemed securities under a balancing of the other three factors nonetheless to be treated as securities if the public has been led to believe they are. It does not, however, allow notes which under the other factors would be deemed securities to escape the reach of regulatory laws. In this case, then, the third Reves factor is basically a wash.

4. The Fourth Reves Factor--Need for Federal Securities Laws
The fourth and final inquiry looks to the adequacy of regulatory schemes other than the federal Securities Acts in reducing risk to the lender. Reves indicates that an alternative regulatory scheme, collateral, and insurance are all capable of reducing the risk to note holders sufficiently to render the protection of federal securities laws unnecessary...
Stoiber argues that "the circumstances of the loans and the creditor/debtor laws of the State of Illinois already provide adequate protection to the lenders." The circumstances he refers to are provisions in the notes for acceleration of payment upon default and recovery of collection costs and attorney fees. We think these are significantly less valuable than collateral or insurance and not by our thinking an adequate substitute for the protection of federal law. Unlike the securities laws, they do not provide any oversight over the initiation of the transactions or Stoiber's handling of the funds. Indeed, part of why the SEC believes that Stoiber's failure to provide his firm notice of the note transactions represents a serious omission is that it denied the note holders the value of oversight by the firm as to how he used the money and whether he fulfilled the note obligations. Unlike collateral and insurance, acceleration provisions and the like in the notes do not guarantee recovery by the note holders if Stoiber loses everything in his commodities investments or defaults for some other reason.
As for protection afforded by Illinois laws, Stoiber's reliance on them would expand the types of alternative protection cognizable beyond those contemplated in Reves...The risk reducing factors described by the Reves Court operate to prevent investors from harm in the first place or, like insurance and collateral, make recovery more likely after injury. In explaining the fourth factor, the Court looked to Marine Bank v. Weaver.. which involved certificates of deposit that were insured by the FDIC and the subject of substantial federal banking regulations... Similarly, the Second Circuit found an alternative regulatory scheme sufficient when the sale of the notes at issue was governed by guidelines of the Comptroller of the Currency. See Banco Espanol de Credito ... The provisions of Illinois law relied on by Stoiber are of a different type; he asserts basically only that state courts are open and that injured note holders can bring lawsuits. Like his "circumstances of the loans," however, this opportunity only operates post-injury and offers much less certainty than collateral and insurance. We do not think Illinois law renders the protection of federal securities law unnecessary in this case.
Comparing Stoiber's notes to character and commercial loans offered by banks also suggests that the protection of federal securities law is not redundant here. We agree with the SEC that bank loans and Stoiber's notes are very different; a bank has the expertise and the access to records needed to carefully assess a person's creditworthiness and financial plans. Stoiber's customers had no such expertise or access. While the long-lasting relationships between Stoiber and his customers did give the note holders personal information about their solicitor not always available to bankers, we do not think this can be an adequate substitute for the

objective data and analytical skills possessed by lending institutions. Information and evaluation of friends based on personal relationships is often subject to manipulation and skewed by other facets of the relationships.

5. The Reves Factors Viewed Collectively
Based on the four Reves factors, then, we conclude that the promissory notes executed by Stoiber are securities. They do not bear a strong enough resemblance to the categories of notes declared by the Supreme Court to be outside the definition of securities and the four factors do not suggest that these notes should be treated as a new non-security category. Admittedly the plan of distribution in part signals that the notes might not be securities, but that factor by itself is not dispositive. See Trust Co. of Louisiana v. NNP Inc. ... ("A debt instrument may be distributed to but one investor, yet still be a security."). The motivations of Stoiber and his customers and the lack of sufficient risk reducing factors other than federal securities laws strongly favor treating the notes as securities, despite the close plan of distribution. The remaining factor--the reasonable expectations of the investing public--is not relevant in this case.

In 2008, the SEC brought enforcement proceedings against **Prosper Marketplace**:[11]

I. The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), against Prosper Marketplace, Inc. ("Prosper" or "Respondent").
II. In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.
III.On the basis of this Order and Respondent's Offer, the Commission finds that:
Respondent Prosper is a Delaware corporation based in San Francisco, California, that owns and operates an online lending platform on its website, www.Prosper.com. Prosper was previously incorporated as JC Capital Solutions, Inc. ("JC Capital"). Prosper is a private corporation and is not registered with the Commission.
Summary: Prosper operates an online lending platform connecting borrowers with lenders. The loan notes issued by Prosper pursuant to this platform are securities and Prosper, from approximately January 2006 through October 14, 2008, violated Sections 5(a) and (c) of the Securities Act, which prohibit the offer or sale of securities without an effective registration statement or a valid exemption from registration.
Prosper's Platform: Prosper's lending platform functions like a double-blind auction, connecting individuals who wish to borrow money, or "borrowers," with individuals or institutions who wish

[11] http://www.sec.gov/litigation/admin/2008/33-8984.pdf .

to commit to purchase loans extended to borrowers, referred to on the platform as "lenders." Lenders and borrowers register on the website and create Prosper identities. They are prohibited from disclosing their actual identities anywhere on the Prosper website. Borrowers request three-year, fixed rate, unsecured loans in amounts between $1,000 and $25,000 by posting "listings" on the platform indicating the amount they want to borrow and the maximum interest rate they are willing to pay. Prosper assigns borrowers a credit grade based on a commercial credit score obtained from a credit bureau, but Prosper does not verify personal information, such as employment and income. Potential lenders bid on funding all or portions of loans for specified interest rates, which are typically higher than rates available from depository accounts at financial institutions. Each loan is usually funded with bids by multiple lenders. After an auction closes and a loan is fully bid upon, the borrower receives the requested loan with the interest rate fixed by Prosper at the lowest rate acceptable to all winning bidders. Individual lenders do not actually lend money directly to the borrower; rather, the borrower receives a loan from a bank with which Prosper has contracted. The interests in that loan are then sold and assigned through Prosper to the lenders, with each lender receiving an individual non-recourse promissory note.

Since the inception of its platform in January 2006, Prosper has initiated approximately $174 million in loans. Prosper collects an origination fee from each borrower of one to three percent of loan proceeds and collects servicing fees from each lender from loan payments at an annual rate of one percent of the outstanding principal balance of the notes. Prosper administers the collection of loan payments from the borrower and the distribution of such payments to the lenders. Prosper also initiates collection of past due loans from borrowers and assigns delinquent loan accounts to collection agencies. Lenders and borrowers are prohibited from transacting directly and are unable to learn each others' true identities.

Discussion: The notes offered by Prosper are investments. Lenders expect a profit on their investments in the form of interest, which is at a rate generally higher than that available from depository accounts at financial institutions. Prosper's website has included statements that the Prosper notes provide returns superior to those offered by alternative investments such as equity stocks, CDs and money markets. The Prosper website has also stated that it offers lenders ways to "spread your risk out and ensure a more reliable return" and describes how lenders are allowed to use payments from an outstanding loan to purchase a new loan "in order to maximize returns." In addition, marketing to institutional lenders on the Prosper website characterizes the platform as an alternative to "stock or bond returns" that is "crucial for prudent portfolio management" in "turbulent markets." Testimonials published on the Prosper website show that customers have used Prosper notes as investment vehicles. Prosper also offers Portfolio Plans that allow lenders to automatically bid on loans based on estimates of risk and return characterized by Prosper.

Lenders rely on the efforts of Prosper because Prosper's efforts are instrumental to realizing a return on the lenders' investments. Prosper lenders are effectively passive with respect to elements important to realizing profit on their investments and Prosper is instrumental in each of these elements. Prosper established and maintains the website platform, without which none of the loan transactions could be effected. Prosper provides mechanisms for attracting lenders and borrowers, facilitating the exchange of information between borrowers and lenders, coordinating bids, and effecting the loans. It provides borrower information to potential lenders via the loan listings, including credit ratings. Prosper provides a matrix for evaluating performance and potential returns in the form of historical loan performance, Prosper

Marketplace and individual borrower performance, and delinquency activity, among other things. Prosper manages the bidding and subscription process for every loan and has the sole contractual right to service the loans, including administering the borrower and lender accounts, and providing monthly statements that reflect payments made and received on the loan notes, as well as amounts available for bidding on new notes.

Furthermore, under the terms of the notes, Prosper has the sole right to act as loan servicer of the notes. In this capacity, Prosper collects repayments of loans and interest, contacts delinquent borrowers for repayment, and reports loan payments and delinquencies to credit reporting agencies. Prosper also exclusively manages the process of referring delinquent loans to collection agencies for payment, and selling defaulted loans to debt purchasers. Since the lender does not know the borrower's identity, the lender would be unable in any event to pursue his or her rights as a noteholder in the event of default. Further, if a lender chooses to participate in Prosper's Portfolio Plan, whereby lenders are permitted to choose portfolios that automatically allocate the lender's funds among various loans based on risk and return characteristics categorized by Prosper, Prosper chooses the loans on which a bid is made.

Lastly, the continued existence and operation of the Prosper platform is essential to the loan transactions taking place. Prosper lenders are too geographically diverse and diffuse to come together without Prosper. They lack the requisite experience to run a loan auction or to create and service a loan package. Rather, the Prosper lenders rely on Prosper's continued operation of the platform in order to transact and to recoup any gain on their investments.

Legal Discussion: The notes offered by Prosper are securities pursuant to Section 2(a)(1) of the Securities Act and under the Supreme Court's decisions in both SEC v. W. J. Howey Co ... and Reves v. Ernst & Young, Inc...

A. Application of the Howey Investment Contract Analysis

Pursuant to SEC v. W. J. Howey Co.... an investment contract exists if there is present "an investment of money in a common enterprise with profits to come solely from the efforts of others."... An investment contract is a security under Section 2(a)(1) of the Securities Act, the offer or sale of which must be registered pursuant to Section 5 of the Securities Act.

The financial instrument offered by Prosper meets the definition of an investment contract as set forth in Howey. As discussed above, there is an investment of money when lenders invest money to purchase a loan. The lenders bear one-hundred percent of the risk of loss each time they fund a Prosper loan because the Prosper loans are non-recourse.

There is a common enterprise for several reasons. For example, a common enterprise exists because lenders and borrowers are dependent on Prosper in order to engage in new loans or to complete the timely repayment of loans already funded. A common enterprise also exists because the vast majority of Prosper loans are funded by more than one lender and because the majority of lenders fund more than one loan. All lenders would be negatively affected if Prosper were unable to operate the platform. In addition, there is a common enterprise between Prosper and its members because borrowers pay Prosper an origination fee of one to three percent of the loan, and each lender pays annual servicing fees to Prosper of one percent of the outstanding principal balance of the notes.

Further, lenders are dependent upon the efforts of Prosper to realize any return on their investment. As discussed above, borrowers and lenders are prohibited from transacting directly and must rely on Prosper to execute each element of the loan creation and repayment process.

B. Application of the Reves Note Analysis

A note is presumed to be a security under the Supreme Court's opinion in Reves v. Ernst &

Young ... unless it is of a type specifically identified as a non-security. The types of non-security notes identified in Reves include notes delivered in a consumer financing; notes secured by a mortgage on a home; short-term notes secured by a lien on a small business or its assets; short-term notes evidenced by accounts receivable; notes evidencing “character” loans to bank customers; notes formalizing open account debts incurred in the ordinary course of business; and notes evidencing loans from commercial banks for ordinary operations... A note that is not among the list identified in Reves is a security unless it bears a “strong family resemblance” to the non-security notes identified in the opinion.... Reves established a four-part family resemblance test to determine whether a note is a security, which is comprised of the following factors: (i) the motivations of the buyer and seller; (ii) the plan of distribution; (iii) the reasonable expectations of the investing public; and (iv) the existence of an alternate regulatory regime.... If a note fails the family resemblance test, it is deemed a security and the offer or sale of such security must be registered pursuant to Section 5 of the Securities Act. The Prosper loan notes are securities under Reves because they do not fall into any of the enumerated categories of non-security notes, and they fail the family resemblance test.

With regard to the motivations of the buyer and seller, as discussed above, Prosper lenders are motivated by the desire to obtain a better return on their money than they otherwise could in another venue. While some Prosper lenders may be motivated, in part, by altruism, altruistic and profit motives are not mutually exclusive....

With respect to the plan of distribution, the Prosper notes are offered and sold on the internet to the public at large. There is no special level of financial sophistication or expertise that Prosper lenders must have. This wide dissemination and solicitation to the public with no attempt to limit investors is indicative of a security.... Pollack v. Laidlaw Holdings, Inc....(concluding that the broad-based, unrestricted sales to the general investing public supported a finding that mortgage participations were securities under federal securities laws).

In analyzing the expectations of the investing public, the lenders in this instance, the relevant issue is what a reasonable investor would believe about the character of the transaction, “even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not ‘securities’ as used in that transaction.” Reves.... The manner in which a transaction is characterized in advertisements is illustrative, and whether there is a “valuable return on an investment, which undoubtedly includes interest.” ... As discussed above, Prosper lenders reasonably expect a valuable return on loaned funds and would reasonably believe that the Prosper loans are investments.

Finally, with regard to whether an alternate regulatory scheme exists to reduce risk to potential investors, there are currently no appropriate regulatory safeguards for Prosper lenders, such as those against misleading statements by a borrower about the purpose of a loan, the borrower’s employment and income, or even the borrower’s identity, or against misleading statements by Prosper.

Thus, the Prosper notes are securities under Reves because: (i) Prosper lenders are motivated by an expected return on their funds; (ii) the Prosper loans are offered to the general public; (iii) a reasonable investor would likely expect that the Prosper loans are investments; and (iv) there is no alternate regulatory scheme that reduces the risks to investors presented by the platform.

As a result of the conduct described above, Prosper violated Section 5(a) of the Securities Act, which states that unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or

medium of any prospectus or otherwise; or to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
Also as a result of the conduct described above, Prosper violated Section 5(c) of the Securities Act, which states that it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security.
IV. In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Prosper's Offer.

The question whether **loan participations** might be regarded as securities was considered in **Banco Espanol de Credito v. Security Pacific National Bank**[12]

Judge Altimari: In 1988, Security Pacific extended a line of credit to Integrated permitting Integrated to obtain short-term unsecured loans from Security Pacific. Security Pacific subsequently made a series of short-term loans to Integrated. Security Pacific sold these loans, in whole or in part, to various institutional investors at differing interest rates. Resales of these loans were prohibited without Security Pacific's express written consent. The practice of selling loans to other institutions is known as "loan participation." Short-term loan participation permits a primary lender such as Security Pacific to spread its risk, while at the same time allowing a purchaser with excess cash to earn a higher return than that available on comparable money market instruments. Security Pacific, as manager of the loans, earned a fee equal to the difference between the interest paid by the debtor and the lower interest paid to the purchaser. Security Pacific assumed no responsibility for the ability of Integrated to repay its loans. Indeed, each purchaser of loan participations was required to enter into a Master Participation Agreement ("MPA"), which contained a general disclaimer providing, in relevant part, that the purchaser "acknowledges that it has independently and without reliance upon Security [Pacific] and based upon such documents and information as the participant has deemed appropriate, made its own credit analysis.
In late 1988, Integrated began to encounter financial difficulties. In April 1989, Security Pacific refused a request by Integrated to extend further credit. Despite this refusal, Security Pacific continued to sell loan participations on Integrated's debt. Indeed, from mid-April through June 9,1989, Security Pacific sold seventeen different loan participations to plaintiffs-appellants. Unable to obtain enough working capital, Integrated began defaulting on its loans on June 12, 1989. Integrated subsequently declared bankruptcy.
As a result of Integrated's default, two sets of investors, who had purchased the seventeen loan participations, initiated separate actions against Security Pacific in the United States District

[12] 973 F.2d 51 (2d Cir 1992). Cert. denied at 509 U.S. 903 (1993). Some commentators have suggested that the federal securities laws should apply to sales of loan participations. See, for example, Richard Y. Roberts & Randall W. Quinn, *Leveling the Playing Field: the Need for Investor Protection for Bank Sales of Loan Participations*, 63 FORDHAM L. REV. 2115 (1995).

Court for the Southern District of New York. Contending that the loan participations were "securities" within the meaning of the Securities Act of 1933 ("the 1933 Act"), plaintiffs sought to rescind their purchase agreements by alleging that Security Pacific had failed to disclose to them material facts about Integrated's financial condition in violation of § 12(2) of the 1933 Act.. Plaintiffs also claimed that Security Pacific's failure to disclose constituted a breach of Security Pacific's implied and express contractual duties under its MPA's, and a breach of Security Pacific's duty to disclose material information based on superior knowledge. Based on these common law claims, plaintiffs sought to recover their investment plus unpaid interest. Plaintiffs in each of the two actions moved for partial summary judgment on the securities claim. Security Pacific cross-moved for summary judgment on all claims. The cases were consolidated for argument.

In ruling on these motions, the district court concluded that the loan participations were not "securities" within the meaning of the Securities Act of 1933, and that, therefore, plaintiffs could not assert a violation under § 12(2) of this Act. In addition, the district court held that the express disclaimer provisions in the MPA precluded plaintiffs' common law claims. Accordingly, the district court granted summary judgment to Security Pacific and dismissed the complaints.... .

It is well-settled that certificates evidencing loans by commercial banks to their customers for use in the customers' current operations are not securities. See, e.g., Reves v. Ernst & Young... However, as the district court noted, a participation in an instrument might in some circumstances be considered a security even where the instrument itself is not...

With respect to loan participations, the district court reasoned that "because the plaintiffs . . . did not receive an undivided interest in a pool of loans, but rather purchased participation in a specific, identifiable short-term Integrated loan, the loan participation did not have an identity separate from the underlying loan." ... Thus, Judge Pollack reasoned, because under Chemical Bank the loans to Integrated were not securities, the plaintiffs' purchase of discrete portions of these loans could not be considered securities.

On appeal, plaintiffs concede that traditional loan participations do not qualify as securities. Instead, plaintiffs contend that the peculiar nature of Security Pacific's loan participation program – which aimed at the sale of 100% of its loans through high speed telephonic sales and often pre-paid transactions – qualified these loan participations as securities. Specifically, plaintiffs argue that the loan participations sold by Security Pacific are more properly characterized as securities--in the nature of "notes"...

In examining whether the loan participations could be considered "notes" which are also securities, the district court applied the "family resemblance" test set forth by the Supreme Court in Reves .. .Under the family resemblance test, a note is presumed to be a security unless an examination of the note, based on four factors, reveals a strong resemblance between the note and one of a judicially-enumerated list of instruments that are not securities. ... If the note in question is not sufficiently similar to one of these instruments, a court must then consider, using the same four factors, whether another category of non-security instruments should be added to the list... The four Reves factors to be considered in this examination are: (1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) 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 addressing the first Reves factor, the district court found that Security Pacific was motivated by a desire to increase lines of credit to Integrated while diversifying Security Pacific's risk, that Integrated was motivated by a need for short-term credit at competitive rates to finance its current operations, and that the purchasers of the loan participations sought a short-term return on excess cash. Based on these findings, the district court concluded that "the overall motivation of the parties was the promotion of commercial purposes" rather than an investment in a business enterprise...

Weighing the second Reves factor--the plan of distribution of the instrument--the district court observed that only institutional and corporate entities were solicited and that detailed individualized presentations were made by Security Pacific's sales personnel. The district court therefore concluded that the plan of distribution was "a limited solicitation to sophisticated financial or commercial institutions and not to the general public."... We agree.

The plan of distribution specifically prohibited resales of the loan participations without the express written permission of Security Pacific. This limitation worked to prevent the loan participations from being sold to the general public, thus limiting eligible buyers to those with the capacity to acquire information about the debtor. This limitation also distinguishes Gary Plastic Packaging v. Merrill Lynch, Pierce, Fenner & Smith, Inc... which involved a secondary market for the instruments traded in that case.

With regard to the third factor--the reasonable perception of the instrument by the investing public--the district court considered the expectations of the sophisticated purchasers who signed MPA's and determined that these institutions were given ample notice that the instruments were participations in loans and not investments in a business enterprise...

Finally, the district court noted that the Office of the Comptroller of the Currency has issued specific policy guidelines addressing the sale of loan participations. Thus, the fourth factor--the existence of another regulatory scheme--indicated that application of the securities laws was unnecessary...

Thus, under the Reves family resemblance analysis, as properly applied by the district court, we hold that the loan participations in the instant case are analogous to the enumerated category of loans issued by banks for commercial purposes and therefore do not satisfy the statutory definition of "notes" which are "securities." Since the loan participations do not meet the statutory definition of securities, plaintiffs may not maintain their action for relief under § 12(2) of the 1933 Act.

We rule only with respect to the loan participations as marketed in this case. We recognize that even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities...

Banking regulators have noted that loan participation programs may involve safety and soundness issues for banks. The following excerpt is from an **Interagency Statement on Sales of 100% Loan Participations** from April 1997[13]:

SAFETY AND SOUNDNESS CONSIDERATIONS
If not appropriately structured, a 100% participation program can present unwarranted risks to the originating institution, including legal, reputation and compliance risks. The policies of a depository institution engaged in the origination of 100% loan participations should address safety and soundness concerns and include criteria for these programs. This criteria should address (1) the program's objectives, (2) the plan of distribution, (3) the credit requirements applicable to the borrower, and (4) the access afforded program participants to financial information on the borrower. In addition, the institution should establish procedures for ensuring compliance with applicable regulations and consistency with the institution's policies and procedures.

ADOPTION OF POLICIES AND PROCEDURES
Participation Agreements. The originating institution should use written participation agreements to set forth the rights and obligations of the parties participating in the program. The agreements should clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. The originating institution should state, unequivocally, that loan participants are participating in loans and are not investing in a business enterprise.
Program Objectives. A 100% loan participation program should be structured to accommodate commercial objectives and not objectives geared primarily to investment in a business enterprise. Therefore, the motivations of the parties involved in the program (the originating institution, the borrower, and the participants) should be of a commercial nature. For example, banks may structure 100% loan participation programs to provide borrowers with short-term credit to finance their current operations, and to provide parties with excess cash the opportunity to obtain a short-term return by purchasing interests in these loans.
Plan of Distribution. The originating institution should take reasonable steps to ensure that the general public does not become the target of marketing efforts as a result of resales by loan participants. For example, the originating institution should have a program in place to ensure that participants are limited to sophisticated financial and commercial entities, and sophisticated persons, and that the participations are not sold directly to the general public. Steps that might be taken by the originating institution include retaining a right of first refusal on any bona-fide offer to a participant from a third party, or requiring the originating institution's permission, not to be unreasonably withheld, before a participant could sell or pledge a loan participation interest.
Credit Condition of the Borrower. The originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements. Loan participations will also have to meet the credit requirements of the loan

[13] The agencies are the Federal Reserve Board (Fed), the Federal Deposit Insurance Corporation (FDIC), The Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). The statement is at http://www.occ.treas.gov/ftp/bulletin/97-21a.pdf .

participants. In the event the originating institution decides to terminate its credit relationship with a borrower, or materially downgrades its relationship with the borrower, the institution should reevaluate whether originating new loans for that borrower for 100% loan participations is appropriate.
Access to Credit Information. The originating institution should allow potential loan participants to obtain and review appropriate credit and other information on the borrower to enable the participants to make an informed credit decision. Promotional materials should clearly state that the participants and not the originating depository institution are responsible for making the ultimate credit decision through the participant's own review of information pertaining to the borrower.

In relation to trading in distressed debt, and in particular trading in claims in bankruptcy, it has been argued that there is another aspect of the definition of a security that is relevant: the investment contract. An investment contract has 3 aspects: (1) investment of money, (2) common enterprise, and (3) profits are expected to be made solely from the actions of people other than the investor. This is the test set out in SEC v Howey.

In his article, Covering the “Security Blanket”: Regulating Bankruptcy Claims and Claim-Participations Trading under the Federal Securities Laws,[14] Thomas Donegan says:

First, purchases of claims and claim-participations from a bankruptcy estate creditor obviously involve the investment of money. Second, the claim purchase creates a commonality of interest between the debtor or reorganized entity and the claim purchaser (or subsequent purchaser), who assumes the role of the assigning claim holder…
…investors purchase claims or interests in claims based on the reasonable expectation of profits. These profits may be realized either from the purchaser’s stake in the newly reorganized entity, from obtaining control of the entity by acquiring a sufficient position in a given class of claims to exercise veto power over the approval of any plan other than its own, or from reselling its claim (or participations therein) at a premium over its purchase price.
Finally, these profits must be expected from the “entrepreneurial or managerial efforts of others.” Whether it be the original claimant or a subsequent claim purchaser who steps into the shoes of the seller, the investor is just one interested party whose economic fate is determined in large measure by the efforts of others: by the debtor-in-possession’s management during the pendency of the case, by the plan proposed by the debtor-in-possession or an alternative plan, and by the outcome of the investor’s class vote on the plan.
Furthermore, even where the investor accumulates a sufficient position to exercise some degree of control, the Supreme Court has determined that the securities laws do not merely protect “passive” investors. In the Court’s view, “eliminating from the definition of ’security’ instruments involved in transactions where control passed to the purchaser would contravene the purposes of these provisions . . . .” Traded claims and claim-participations therefore exhibit all of the necessary attributes to be considered “investment contracts,” and thus are securities under the Howey test.

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[14] 14 Bank. Dev. J. 381 (1998).

Donegan also argues that the courts' analysis of pre-petition claims in relation to loans and loan participations that results in them not being treated as the sort of notes which are securities should apply differently in the context of post-petition claims.

The Development of a Secondary Market in Loans

Syndicated loans are now described as an "asset class". We have already noted that there are firms which buy distressed debt in the secondary market. However, firms may also buy and sell debt which is not distressed. Other firms facilitate the secondary market in syndicated loans by providing pricing services[15] and brokerage services. The Loan Syndications and Trading Association[16] produces standard forms to facilitate the secondary market in loans. In 2002 a pilot program for CUSIP (Committee on Uniform Security Identification Procedures) numbers (in the US and Canada) for syndicated loans was launched. CUSIP numbers facilitate the clearing of trades in securities.[17] The LSTA press notice stated:

Key benefits of utilizing the CUSIP Standard as a Unique Common Loan Identifier
The CUSIP system establishes a common numbering system to reference syndicated loan credits. Presently, different identification numbers represent the same credit in proprietary systems utilized by various market participants, such as administrative agents, lenders, traders, potential buyers, regulators and various vendors to the market including pricing services and rating agencies. The use of a single CUSIP Number as a unique common identifier for all market participants will facilitate proper crediting of money movements, focus inquiries, create a common reference for market pricing and enable a more orderly exchange of information in an automated environment.
A critical advantage offered by the CUSIP numbering system is that it is endorsed by ANSI (the American National Standards Institute) and by ANNA (the Association of National Numbering Agencies). The CUSIP system conforms to ANNA's global guidelines that enable its members and the financial industry worldwide to adhere to standards and procedures for the creation, modification and deletion of unique identifiers. Adherence to ANNA's standards facilitates linking and cross-referencing separate local numbering systems in over 60 countries.
It is expected that the adoption of CUSIP numbers for syndicated loans will bring the following benefits:

* The precise exchange of information for drawdowns, repayments and fundings
* Improved reconciliation for inquiries and investigations

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[15] See, e.g. http://www.loanpricing.com

[16] http://www.lsta.org/

[17] See http://www.cusip.com/

* Improved communication of information to the national banking regulators for Shared National Credit reviews
* Ease in utilizing internet-based trading and settlement platforms to exchange trade information and documents
* Increased efficiencies and improved settlement times for secondary assignments of loans
* Improved communication between front/middle/back office and counterparties regarding traded assets
* Enhanced reporting capabilities related to the settlement process
* Updated mark to market valuation information and ultimately automated feed of that information
* Assistance in providing automated feeds for updating ratings assigned by credit rating agencies

The adoption of CUSIP Numbers for syndicated loans is endorsed by members of the FFIEC (the Federal Financial Institutions Examination Council) and is expected to be used in Shared National Credit reporting. The NAIC (National Association of Insurance Commissioners) requires regulated insurance institutions to use CUSIP Numbers in making their financial reports.