

# Court Tests a Borrower's Ability to Block Loan Transfers to Competitors

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A recent decision by Judge Jed S. Rakoff of the United States District Court for the Southern District of New York, which granted a borrower's motion for a preliminary injunction blocking the sale of a participation in the borrower's loan, seemingly expands borrowers' power to prevent lenders from transferring loans by participation even when the participation is permitted by the governing credit agreement.<sup>1</sup> The decision has the potential to create uncertainty in the secondary loan market and should cause loan traders and lawyers to tread carefully when interpreting the "plain language" of loan transfer provisions. This memorandum describes Judge Rakoff's decision and the broader commercial context within which the issues arise in the loan market.

The secondary market for commercial bank loans has expanded exponentially in the last two decades, and the "loan trading model" has, to some extent, supplanted the "relationship banking model" as the paradigm lenders and borrowers use to define their long-term dealings. Within this new model, liquidity is paramount and market participants use time-tested transfer agreements and legal structures to efficiently transfer bank loans from an existing lender to a new lender.<sup>2</sup> If the transfer is by "assignment," the assignee becomes a new "lender of record" under the credit agreement. As a result, the new lender assumes the rights and obligations of the original lender, and the original lender is released from the contract. Because the contractual relationship between the borrower and the original lender is supplanted by the new contractual relationship between the borrower and the

assignee, an assignment normally requires the written consent of the borrower.

Conversely, if the transfer of the loan to the third-party is done as a participation, the contractual relationship between the borrower and the original lender remains intact. The seller of the participation remains the lender of record, and the buyer of the participation is granted a beneficial ownership interest in the loan which includes the right to (i) share in the economic benefits and burdens of the loan, (ii) receive confidential information provided to lenders by the borrower, and (iii) vote on important lender decisions under the credit agreement. Hence, because a participation does not affect the legal relationship between the original lender and the borrower, the borrower's consent to a participation is typically not required. In any event, the ability of the lender to sell assignments or participations in a loan is spelled out in the credit agreement, which is negotiated and agreed upon between the lender and the borrower at the time the loan is made.

Like all syndicated loan agreements entered into between lenders and borrowers, the Credit Agreement at issue in *Cablevision v. JP Morgan* provided two mechanisms by which JP Morgan (the "Lender") could syndicate the \$225 million loan (the "Loan") it made to Cablevision (the "Borrower") in December of 2007 – by selling assignments of the Loan or by granting participations in the Loan. Because any assignment would sever the contractual relationship between Lender and Borrower and replace Lender with a new party, the Credit Agreement provided that Borrower's prior consent was required for any assignment.

## Memorandum

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<sup>1</sup> *Empresas Cablevision, S.A.B. v. JP Morgan Chase Bank*, 09 Civ. 9972 (JSR), 2010 U.S. Dist. LEXIS 8896 (S.D.N.Y. Jan. 28, 2010).

<sup>2</sup> Among the benefits of the loan trading model are diversification of a lender's portfolio of loans to avoid overconcentration in specific industry or geographical sectors.

The Credit Agreement permitted the sale of participations without the Borrower's consent. As customary, the Credit Agreement provided that any participation agreement would ensure that (i) Lender's obligations and responsibilities under the Credit Agreement remained intact, (ii) Borrower would continue to deal directly with Lender, and (iii) Lender, and not the participant, had the sole ability to enforce the terms and conditions of the Credit Agreement. In essence, the Credit Agreement ensured that if Lender sold a participation in the Loan, it would not alter the existing contractual relationship between Lender and Borrower. These conditions are standard in any syndicated loan agreement.

Because the sale of a loan by assignment or participation is provided for in all syndicated loan agreements, to determine whether a particular assignment or participation is permitted, and under what conditions, the parties must look to the express terms and conditions of the governing credit agreement. It is black-letter law that a clear and unambiguous contract should be enforced according to its plain meaning, and the parties to the contract should be able to rely upon those clear and unambiguous terms to avoid a breach and a resulting damage claim.

Every contract also contains an implied covenant of good faith and fair dealing. This implied covenant requires that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." Although this implied covenant necessarily introduces some uncertainty into the relationship between the contracting parties, it is very rare for a court to find that, although there was no breach of an express term or condition of a contract, the implied covenant of good faith and fair dealing was breached.

In *Cablevision v. JP Morgan*, however, that's exactly what happened. The Court held that Lender had not breached the express terms of its credit agreement pursuant to which it loaned \$225 million to Borrower.

(Decision at 12-13.) The Court, however, held that Lender had breached its contractual duty of good faith and fair dealing, and the Court enjoined JP Morgan from granting a 90% participation in the loan to a bank that had "common ownership with a major competitor of Cablevision" despite (i) the absence of any term in the Credit Agreement prohibiting such a transaction, and (ii) the fact that the Credit Agreement specifically provided that the Lender could sell participations in the Loan without the Borrower's consent.

This case is significant for the secondary market in bank loans because, in ruling that the participation challenged here violated the implied covenant of good faith and fair dealing present in every contract, the Court has created uncertainty as to when a participation can be used after the borrower has refused to consent to an assignment. It is also significant because, just as parties to a contract take comfort from the "plain meaning" of the contract to govern their behavior, the secondary loan market relies upon, and takes comfort from, the plain meaning of customary agreements that are uniformly interpreted by market participants. *Cablevision v. JP Morgan* has the potential to disrupt market expectations.

The facts are critical to the Court's decision. In December 2007, Borrower moved to acquire Mexico's third-largest fiber-optic company, Empresas Bestel. To finance this acquisition, Borrower borrowed \$225 million from JP Morgan. JP Morgan failed to syndicate the Loan. JP Morgan subsequently tried to assign a substantial portion of the loan to a single lender, Banco Inbursa ("Participant"), a Mexican bank controlled by Carlos Slim Helu and his family ("Slim"). Slim also held a controlling interest in Telemex, a Mexican communications conglomerate that is a primary competitor of Cablevision.

Borrower refused to consent to Lender's assignment of the Loan to Participant because providing a major competitor with access to confidential and competitively sensitive information or the ability to exert any control over Borrower's business affairs and

business development would cause serious harm to Borrower.

Faced with Borrower’s refusal to consent to the proposed assignment, Lender negotiated a transfer of a 90% participation in the Loan to Participant (the “Participation Agreement”). The Participation Agreement, which was entered into between Lender and Participant on July 15, 2009, contained a number of key provisions: (i) the agreement permitted Participant to request and receive extensive information from Borrower; (ii) the agreement provided that if Borrower defaulted on the loan, the participation would turn into an assignment, and Participant would become the lender; (iii) the agreement gave Participant not only a 90% share of Borrower’s principal and interest payments due under the loan, but it also gave Participant 90% of the fees earned by Lender under the Credit Agreement, and; (iv) the agreement gave Participant the right of first refusal with respect to the transfer of the remaining 10% of the loan held by Lender.<sup>3</sup>

When it discovered Lender’s plans to sell the Participation, Borrower sued Lender for breach of contract, alleging that the Participation Agreement was really an “assignment”, and that this assignment had been entered into without Borrower’s consent, in violation of the Loan Agreement. In the alternative, Borrower argued that even if the Participation Agreement technically complied with the Loan Agreement, the unusual structure of the Participation Agreement gave Participant the substance of an assignment. This, Borrower argued, undercut the “assignment veto” that it had negotiated for in the Loan Agreement, thereby violating the implied covenant of good faith and fair dealing.

The Court declined to rule that Lender had breached the terms of the Credit Agreement by entering into the Participation Agreement with Participant.<sup>4</sup> However, the Court concluded that Lender acted in bad faith by using the “guise of a purported ‘participation’ to effectuate what [wa]s in substance a forbidden assignment.”<sup>5</sup> It followed, according to the Court, that Lender had deprived Borrower of the benefit of the contract -- Borrower’s veto power over assignments.

Of paramount importance to the Court was the fact that Participant was owned by the major shareholder of one of Borrower’s major competitors. Indeed, as the Court noted, under “the Participation Agreement, [Participant], a bank under common ownership with [Borrower’s] major competitor, was given, at [Participant’s] request, rights that were not part of [Lender’s] standard participation agreement that enabled [Participant] not just to receive [Borrower’s] confidential information, but to use [Lender] as a vehicle for demanding such information on a virtually unlimited basis.” Clearly, the Court concluded, the assignment veto, negotiated for by Borrower, was, among other things, designed to prevent sharing of confidential information among Borrower’s competitors.

The court was clearly sympathetic to Borrower’s situation. Yet, in ruling for Borrower, the Court overlooked several key considerations. It is well-understood that a borrower’s confidential information is only shared with assignees and participants pursuant to a confidentiality agreement restricting the use or dissemination of the information with potential purchasers of the loan or interests in the loan. Indeed, the Participation Agreement negotiated between Lender and Participant required Participant to maintain the confidentiality of any confidential

<sup>3</sup> Participations are perhaps the least standardized form of transfer agreement in the secondary loan market and are often subject to extensive negotiation of material economic and legal points. The specific resolution of the economic information flow and governance issues negotiated by Lender and Participant in the Participation Agreement may not be “market-standard”, but they do not appear to contravene the requirements of the Credit Agreement, which describe the essence of a participation: (i) Lender’s obligations and responsibilities under the Credit Agreement remain intact, (ii) Borrower continues to deal directly with Lender, and (iii) Lender, and not the participant, has the sole ability to enforce the terms and conditions of the Credit Agreement.

<sup>4</sup> Indeed, given that under the participation JP Morgan’s rights and responsibilities as the Lender remained intact and JP Morgan retained the sole authority to enforce and amend the loan documents, such a finding would have been contrary to the express terms and conditions of the Credit Agreement.

<sup>5</sup> Specifically, the court held that “after failing to obtain Cablevision’s consent to an assignment of 90% of the loan to [Participant],” JP Morgan “negotiated an agreement with [Participant] that, while it took the form of a participation, gave [Participant] much of the substance of the forbidden assignment and purposely undercut what JP Morgan knew the assignment veto was designed to prevent.”

materials it received from Borrower, and other provisions within the Participation Agreement narrowed the specific confidential information to which Participant was entitled.

Most importantly, Participant was merely an affiliate of a competitor (Telemex), and not itself a competitor.

The Court did not discuss whether Borrower could reasonably presume or anticipate that Participant would breach Participant's confidentiality obligations by sharing Borrower's confidential information with an affiliate. If the plain meaning of a contract controls, then Borrower could have negotiated provisions in the credit agreement prohibiting (i) any sale of a participation by the lender to a "competitor (or affiliate of a competitor)" of the Borrower, or (ii) the sharing of confidential information with "competitors (or affiliates of competitors)".

The Court was obviously troubled by the special terms of the participation, especially the provision governing the sharing of confidential information. However, the terms of the participation agreement that Lender negotiated with Participant, while not boilerplate, are not uncommon in participation agreements generally. The *Cablevision v. JP Morgan* decision creates uncertainty in the market and leaves open the question whether the grantor of a similar participation should attempt to obtain the consent of the borrower notwithstanding clear provisions to the contrary in most credit agreements.

In the wake of *Cablevision v. JP Morgan*, prudent practice in the secondary loan market requires loan transfer provisions and eligible assignee definitions to be read literally and in light of the implied covenant of good faith and fair dealing, which applies by law to all contracts. A borrower's denial of consent to a proposed assignee who is a competitor, or a credit agreement clause that expressly prohibits transfer by assignment to the borrower's competitors, may mean that a transfer by participation is not available even though such a participation is arguably permitted by the terms of the credit agreement.

On appeal from the Court's grant of a preliminary injunction, *Cablevision v. JP Morgan* is currently headed up to the Second Circuit Court of Appeals, although the case is also scheduled for a full trial on the merits before Judge Rakoff on July 26, 2010. The loan market will continue to watch the case with interest.

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