

Recharacterization Issues in Participating Loans

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Introduction

A “lead” or “agent” bank will often agree with another bank or financial institution, or several banks or financial institutions, to “participate” the loan, i.e., to transfer an interest in a portion of the mortgage loan and the underlying debt obligation either prior to the closing of the loan or after the loan has closed. The lead lender will commonly retain a portion of the loan and be the mortgagee of record, hold the debt instrument (or instruments) in its possession, and will be responsible for maintaining and servicing the loan, collecting the debt payments and enforcing the terms of the loan documents. The lead lender also will be responsible for delivering to each participant its proportionate share of the loan payments that it collects from the borrower, and will assume certain disclosure and other obligations to the participant(s), all as contained in the participation agreement between the lead lender and the participant(s).

Relationship Between Co-Lenders

The relationship between the lead lender and the participating lender or lenders may involve an underlying loan that is either secured or unsecured. Lenders should be aware that the characterization of a participation interest might affect the ability of the lead lender, or a participant, to deal with the collateral when the loan is in fact secured by an interest in real property.

A loan participation agreement generally is construed as an arms-length commercial contractual relationship that will be enforced in accordance with its terms. See, e.g., *In re Colocotronis Tanker Securities Litigation*, 447 F. Supp. 828, 833 (S.D.N.Y. 1978) (“[Participation] agreements are arms length contracts between relatively sophisticated financial institutions and do not establish fiduciary relationships...”); *Natwest USA Credit Corp. v. Alco Standard Corp.*, 858 F.Supp. 401, 407-08 (S.D.N.Y. 1994) (“A participation is not a loan. To the contrary, a participation is a contractual arrangement between a lender and a third party whereby the third party, labeled a participant, provides funds to the lender. . . . The participant is not a lender to the borrower and has no contractual relationship with the borrower”). See also *First Bank of WaKeeney v. Peoples State Bank*, 12 Kan. App. 2d 788, 790-791, 758 P. 2d 236, 238-239 (1988); *New Bank of New England v. Toronto Dominion Bank*, 768 F. Supp. 1017, 1021 (1991).

There are several other possible characterizations of the relationship between a lead lender and a participating lender (or lenders), and one or more of the following characterizations may be determined by a court to exist as a result of the contractual or other relationship of the parties.

1. A loan of a portion of the loan proceeds by the participant to the lead lender, which loan is secured by an unperfected transfer of the underlying loan. *See Came Realty LLC v. DeMaio*, 746 N.Y.S. 2d 555, 556 (N.Y. Supp. Ct. 2002) (holding that “fractional assignments of mortgage” issued to investors did not entitle them to proceeds from foreclosure sale and gave them only an unperfected security interest in the mortgagor’s note; the court stated that, “[a] guaranteed return of investment, participation that lasts for a shorter period of time than the underlying obligation, different payment arrangements between borrower and lead lender and lead lender and participant, and a discrepancy between the interest rate in the underlying note and the interest rate specified in participation, are the factors indicating an intention to create a loan instead of a mortgage participation plan” (citations omitted)).
2. A sale and purchase of interest in the loan, in which the participant would have acquired an undivided interest in the loan (including the security for the loan).
3. A trust relationship between the lead lender and the participant, whereby the lead lender holds title in trust for the participant as a “beneficiary,” to the extent of the interest transferred.
4. A joint venture, tenancy-in-common, or partnership.
5. An agency relationship, whereby the participant is deemed to be the principal and the lead lender an agent of the participant with respect to (at a minimum) collection of payments due under the loan.
6. The sale of a security (i.e., the participation interest).

See Dennis Arnold, *Loan Participations: A Conceptual Overview*, Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5, 1997), Tab 7, p. 3.

Characterization of Participation Agreements in Bankruptcy

Although bank groups (especially groups involving both foreign and domestic banks) usually execute an agency agreement, the agent or lead lender may not always be acting (or be obligated to act) in the best interests of, or at the

direction of, each of the participants. Such agency agreements commonly provide for a majority vote as opposed to a unanimous vote. If the agent votes the claims of the members of the group in a bankruptcy proceeding, a dissenting member conceivably could claim that the voting of its individual claim was impermissible under the Bankruptcy Code and the Bankruptcy Rules. This tactic could result in extensive litigation and possible objection to confirmation of the plan based on the placement of several banks' claims and interests into one class of creditors. The success of this argument may depend on whether the loan participants are in fact deemed by a bankruptcy court to have discrete claims that may be asserted separately from the claim asserted on behalf of the group by the agent or lead lender. See, e.g. *In re 203 N. LaSalle Street Partnership*, 246 B.R. 325 (Bankr. N.D. Ill. 2000). In this case the bankruptcy court rejected the bank's requested relief with respect to voting the claim of a subordinated lender in accordance with the subordination agreement between the parties. The court found that § 510(a) of the Code, which provides that a subordination agreement is enforceable in bankruptcy to the same extent enforceable under nonbankruptcy law, "does not allow for waiver of voting rights under Section 1126(a)." Section 1126(a) of the Code provides that "[t]he holder of a claim" may vote to accept or reject a plan under Chapter 11. According to the court, since voting is covered explicitly by §1126(a), its provisions trump contrary provisions in private pre-petition agreements -- much like the Code does not permit a debtor to contract away its discharge -- and "[s]ubordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights." *Id.* at 331. The court further stated that "it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply." *Id.* The court also held that § 3018(c) of the Bankruptcy Rules does not allow the secured creditor to vote a subordinated creditor's claim. This rule provides that "the creditor or equity security holder or an authorized agent" must sign an acceptance or rejection of a Chapter 11 plan. The court dismissed the Bank's argument that it was an "agent" of the general partner pursuant to the written agreement, because in voting the claim it would be acting in its own interests and not the general partner's. The court looked to the substance of the relationship, and found that the parties cannot contract in advance for this status consistent with either §1126(a) or § 3018 of the Bankruptcy Rules.

However, the bankruptcy court's refusal to enforce the consensual transfer of the subordinate lender's voting rights in *203 North LaSalle* is problematical, and does not appear to be warranted by either the facts of this case or other case law in this area. Unlike pre-petition agreements between the debtor and a secured creditor providing for automatic lift of the stay or the waiver of other rights by the debtor or the consent to certain actions of the first mortgage lender by the debtor (e.g., to not oppose a reorganization plan submitted by the secured creditor), the agreement in *203 North LaSalle* was voluntarily entered into solely by creditors of the bankruptcy estate, i.e., the debtor was not a party to the agreement. No public policy is violated in this factual situation, especially since there is no expectation of any recovery for the subordinate lienholder. (In *203 North LaSalle*,

the Bank's first-position secured lien was valued at \$54.5 million, and the indebtedness owed to the Bank by the debtor was \$93 million).

The trading in and assignment of claims among creditors is common and is supported by case law, as well as the Code and Bankruptcy Rules. Although a bankruptcy court may invalidate a vote that was not made or obtained in good faith, a creditor is not prohibited from assigning or transferring its vote, or right to vote, to another person or entity after a bankruptcy petition has been filed by or against the debtor. Section 1126(e) of the Code permits a court to disqualify the votes of any entity whose acceptance or rejection of a plan was not incurred in good faith. Under the Bankruptcy Rules, the courts are authorized and empowered to resolve disputes and enter appropriate orders in connection with such transfers and assignments. Section 3001(e) of the Bankruptcy Rules restricts the bankruptcy court's role to the adjudication of disputes regarding the transfers of claims. For the most part, if the transferor does not object, then the transfer is automatically approved without a court order. Section 3001(e) of the Bankruptcy Rules is not intended either to encourage or discourage post-petition transfers of claims or to affect any remedies that are otherwise available to a transferor or transferee under non-bankruptcy law, such as the remedy for misrepresentation in connection with the transfer of a claim. In general, purchasing claims is permitted if full and proper disclosure is made and if the purpose of the purchase is not to increase the creditor's recovery at the expense of the other creditors.

Although case law is sparse in this area -- probably because most disputes are resolved through voluntary and consensual compromises as to the respective positions and recoveries of the parties in order to prevent costly and time-consuming litigation -- other bankruptcy court decisions generally have held that voting rights may be transferred to another creditor as part of an intercreditor or subordination agreement, and that such assignments are valid and enforceable as bargained-for contractual rights. In *In re Curtis Center Ltd. Partnership*, 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996), the subordinate lienholder had entered into a subordination agreement with language remarkably similar to that contained in the intercreditor agreement executed by the first and second lienholders in *203 North LaSalle* (i.e., providing that the first lienholder was authorized, on behalf of the junior lienholder, to file all claims and proofs for the full outstanding amount of the junior debt and to "prove and vote or consent in any proceedings with respect to [the junior] debt"). The court ruled that the junior lender could not vote on the debtor's plan because of the "plain and unambiguous" language in the subordination agreement, the clear language of Section 510(a) of the Code as to the validity and enforceability of intercreditor agreements, and the inapplicability and irrelevance of the junior lienholder's implied argument that it could ignore the plain language of the subordination agreement because it was to be paid, as part of the debtor's plan, from some "source other than the debtor." See also *In re Itemlab, Inc.*, 197 F.Supp. 194, 197-98 (Bankr. E.D.N.Y. 1961) (holding that where senior creditor would not

recover full amount of its claim and junior creditor would therefore receive nothing, junior creditor was deemed to have made an equitable assignment of its claim and senior lender was entitled to vote junior lender's claim even though subordination agreement was silent as to voting of claims in bankruptcy proceedings); *In re Inter Urban Broadcasting of Cincinnati, Inc.*, 1994 WL 646176 (Bankr. E.D. La., Nov. 16, 1994) (approving assignment of vote in subordination agreement); *In re Southland Corp.*, 124 B.R. 211, 225-27 (Bankr. N.D. Tex. 1991) (holding that notwithstanding § 3018 of the Bankruptcy Rules, which grants record holders of claims right to vote on Chapter 11 reorganization plans, beneficial owners of securities, not record holders, were actual "holders" of right to vote within meaning of § 1126(b) of the Code).

However, other courts have refused to enforce provisions in intercreditor or subordination agreements that permitted the senior lender to vote the bankruptcy claim of a junior lender, or have strictly construed the language in such agreements to prevent the senior lender from exercising the junior lender's right to vote. See, e.g., *In the Matter of Alda Commercial Corp.*, 300 F.Supp. 294, 296 (Bankr. S.D.N.Y. 1969) (permitting junior creditors to vote for trustee at first meeting of creditors, before determination of whether some creditors were subordinated as to eventual payment); *Beatrice Foods Co. v. Hart Ski Mfg. Co., Inc. (In re Hart Ski Mfg. Co., Inc.)*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (stating, in *dicta*, that regardless of subordination the subordinate lender retains the right to "to assert and prove its claim" and to "participate in the voting for confirmation or rejection of any plan of reorganization"); *First Nat'l Bank of Hollywood v. American Foam Rubber Corp.*, 530 F.2d 450, 454-56 (2nd Cir. 1976) (upholding right of subordinated creditor to discharge an unmatured subordinated indebtedness without consent of senior creditor, and stating that "if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement").

In *In re Sentry Operating Co. of Texas, Inc., et al.*, 264 B.R. 850 (Bankr. S.D. Tex. 2001), the debtors had entered into a \$20 million credit facility with two banks for the acquisition and operation of several small-town funeral homes. The banks held liens and security interests against the properties pursuant to a credit agreement with the debtors. In addition, certain other bank equity investors had purchased \$2 million worth of senior subordinated notes issued by the debtor ("Notes"). The Notes contained an explicit provision stating that during the continuance of any default in payment of the senior secured indebtedness, the noteholders would subordinate their right to payment until the senior lienholders were paid in full. The Notes also contained a provision that if the borrower-debtors were liquidated any payment otherwise due to the subordinate lienholders would be paid to reduce the senior indebtedness. The Notes further provided that the noteholders would not vote their claims "in a manner inconsistent with the terms of this Section." Notwithstanding this express language, the subordinated investors voted against the Chapter 11 bankruptcy plan approved by the senior lienholders. The senior lienholders filed a motion to

disqualify the votes of the subordinated investors, alleging that the clear language of the subordination provision in the Notes prohibited them from voting against the plan so long as the senior indebtedness had not been paid in full. The court acknowledged that subordination agreements are enforceable in a bankruptcy case and that the subordinate noteholders had clearly subordinated their claims.

But the court noted that the proposed plan provided for greater payment to trade creditors (who were placed in their own class and would receive 100% of their claims, as opposed to the subordinate noteholders who were placed in a separate class and would receive 1% of their claims). The court found that the subordination provision in the Notes only provided for subordination to payment of the senior indebtedness, not to a plan that allowed payment of trade debt in preference to payment of the subordinated investors; i.e., the subordination provision in the Notes explicitly provided that the claims of the subordinated noteholders were not subordinated to other unsecured claims. Therefore, the court ruled, the subordinated noteholders were “not prohibited from voting against a plan that subordinates them to trade creditors of equal rank.” *Id.* at 858. Because the plan provided for greater payment to trade creditors than to the subordinate investors, the court held that “[t]his violates the [the subordination section] of the Notes. Consequently, a vote against such plan is in accordance with [the subordination section of the Notes], not violative of it.” *Id.* The court acknowledged that the subordinate investors would be prohibited from voting against a plan that provided for payment of all funds to the secured senior lenders or that provided for equal payment to trade creditors and other secured creditors. This case clearly illustrates the importance (as noted earlier in this article) of drafting clear and comprehensive language in subordination agreements to reflect the intent of the parties.

In *In re Okura & Co.*, 249 B.R. 596 (Bankr. S.D.N.Y. 2000), the bankruptcy court held that the participation agreement between the lead or “agent” bank and another lender was a “true loan participation,” which did not result in a partial assignment of the lead lender’s right to payment from the debtor or otherwise give the participating bank lender any right to payment from the debtor. The court ruled that the participating bank was entitled only to share in the proceeds upon the debtor’s repayment of the loan, and that the participating bank did not have any “claim” against the debtor which would give it “creditor” status in the debtor’s Chapter 11 bankruptcy proceeding. The court noted that the participation agreement between the lead lender and the participating bank contained language stating that the lead lender retained the exclusive right to assert a claim against the debtor and that the participating bank would have no interest in the collateral for the loan. According to the court, “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 (citations omitted).” *Id.* at 608. The court further ruled that the loan participation agreement

did not constitute a tenancy in common under New York law, because only the lead lender had entered into the underlying loan agreement with the debtor.

The *Okura* case contains a discussion of the law of participation agreements in general, including the difference between participation agreements (which the court characterizes as “true participations”), interbank loans, and syndication agreements. According to the court:

“The most common multiple lending agreement is the loan participation agreement, which involves two independent, bilateral relationships; the first between the borrower and the lead bank and the second between the lead bank and the participant (citation omitted). As a general rule, the participants do not have privity of contract with the underlying borrower (citation omitted). 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 (citation omitted).”

Id.

See also *In re Autostyle Plastics, Inc.*, 269 F.2d 726, 737-38 (6th Cir. 2001) (stating that “[t]he facts indicate that the parties intended the transactions to be true participation agreements,” and that the participation agreements were valid, legal, and enforceable and gave the lead lender “the sole right to seek legal recourse against the borrower”).

Uniform Commercial Code Issues

In *Came Realty LLC v. DeMaio*, *supra*, 746 N.Y.S. 2d at 556, the court stated that, “in the case of a collaterally assigned note, the assignee must take possession of the note in order to perfect its security interest.” The court, in finding that the investors in the note (after the mortgage was executed and recorded) had no interest in the foreclosure proceeds when the assignee of the mortgage filed a foreclosure proceeding, also stated that “the investors never took possession of the original . . . note and mortgage which were retained by [the mortgagee of record].”

Effective July 1, 2001, the rules regarding interests in promissory notes under the Uniform Commercial Code (“UCC”) dramatically changed. This was done in an attempt to accommodate asset securitization; the asset-based commercial-paper market currently holds \$708 billion in assets (up from \$517 billion in 1999), and is by far the most rapidly growing segment of the U.S. credit markets.

Former Article 9 of the Uniform Commercial Code classified a promissory note as an instrument, and the sale of an instrument was outside the scope of

Article 9. In 2001, revised Article 9 ("Revised Article 9") of the UCC was enacted into law in every state. Revised Article 9 expressly includes the sale of promissory notes within its scope. See UCC sec. 9-109(a)(3). However, there are some limitations:

1. Sales of promissory notes as part of the business from which they arose;
2. Assignments of promissory notes for collection only; and
3. Assignments of promissory notes to an assignee in satisfaction of indebtedness

These exclusions typically do not effect securitization transactions.

Sec. 109(b) of Revised Article 9 provides (as did Former Article 9) that "[t]he application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply." However, Comment 7 to this section makes clear the views of the drafters that a recorded assignment of a mortgage has no bearing on whether a security interest in the mortgage is created or perfected and that any cases to the contrary are overruled. According to Comment 7, "an attempt to obtain or perfect a security interest in a secured obligation by complying with non-Article 9 law, as by an assignment of record of a real-property mortgage, would be ineffective . . . [O]ne cannot obtain a security interest in a lien, such as a mortgage on real property, that is not also coupled with an equally effective security interest in the secured obligation."

A buyer of an interest in a promissory note should enjoy automatic perfection under Revised Article 9, but should also file a UCC-1 Financing Statement in case the seller/originator's bankruptcy trustee subsequently alleges that the transaction was really a loan and not a sale. Methods of perfection can create problems for the escrow holder and the borrower/debtor. The method of perfection of a security interest in a promissory note depends on whether the transaction involves a "sale" of that type of property or a "loan" secured by that type of property. To perfect an interest in the note, the buyer/lender should, if the interest is a:

- a. "Loan secured by interest in promissory note": Perfect by possession or filing. See UCC secs. 9-312(a) and 9-313(a). Since possession of the note is not always practical, in many instances filing of a UCC-1 may be only way to perfect. A bona fide purchaser in possession will prime perfection by filing!
- b. "True Sale" of an interest in a promissory note: Be aware that neither filing nor possession is necessary or effective to perfect the security interest. Perfection is *automatic* upon attachment if the "security interest" results from the sale of the promissory note. See UCC

sec. 9-309(4). Once perfected, the security interest takes priority over the interest of a subsequent lien creditor and the originator/debtor's bankruptcy trustee. See UCC sec. 9-317(a)(2); 11 USC sec. 544(a)(1).

In addition, to accommodate the practice of warehouse lending, Revised Article 9 provides that a secured party does not relinquish possession of the mortgage if a mortgage warehouse lender delivers the original note to prospective purchasers. It need only instruct the third party that it is to hold for the benefit of the secured party, and to re-deliver the collateral to the secured party. See UCC sec. 9-313(h), cmt. 9.

Because perfection can be done without filing, and possession of the instrument is not determinative of ownership, and because UCC sec. 9-203(g) states that the mortgage follows the note, the original maker of the note and an escrow holder cannot rely on the public records to determine who owns the note and who can sign a reconveyance or release of the mortgage. Revised Article 9 does not protect the original maker, nor provide advice on how to determine whom to pay. Revised Article 9 simply states that the "issues are determined by real-property law". The Comments to UCC Sec. 9-109 of Revised Article 9 also state that any attempt to obtain or perfect a security interest in a mortgage by complying with non-Article 9 law (such as recording a collateral assignment of the beneficial interest) would be ineffective. Purchasers of interests in promissory notes and the underlying debtors must rely on representations and the financial stability of originators/sellers to determine who really owns the interest. See UCC sec. 9-308, cmt. 6.

Some commentators, viewing this phenomenon from the maker/account debtor's perspective, refer to this set of facts as an "invisible lender scenario" because the debtor under the mortgage-secured note will not be able to ascertain what has occurred through examination of the public records (including who has the right to execute a reconveyance or release of the mortgage).

If the maker of the note cannot determine whom to pay, and recording of a collateral assignment of the beneficial interest is ineffective and not indicative of ownership, failure to rely on the public records by the escrow holder should not be the basis of a breach of fiduciary duty cause of action. Reliance on the public records would be foolhardy and may even be actionable negligence.

As noted above, an absolute assignment of a promissory note carries with it the securing mortgage without the requirement of physical delivery of either the note or mortgage. Attachment of a security interest in a promissory note (which automatically includes the attachment of a security interest in the securing mortgage) requires either a security agreement authenticated by the debtor or possession of the collateral by the secured party pursuant to an agreement. See UCC secs. 9-309(4) and 9-203. Under the "principal/incident" view of the note/mortgage relationship, UCC secs. 9-203(g) and 9-308(e) provide that

attachment of a security interest in a promissory note is also attachment of a security interest in a securing mortgage, and the perfection of a security interest in a promissory note is also perfection of a security interest in a securing mortgage.

It should be noted that Revised Article 9 ostensibly makes it easier for a secured party with a security interest in a promissory note to foreclose a mortgage securing the note. After the debtor/mortgagee's default, the secured party may exercise the debtor/mortgagee's rights with respect to any property that secures the debtor/mortgagee's obligations. See U.C.C. sec. 9-607(a)(3).

The secured party does not have to foreclose on the promissory note in order to foreclose on the mortgage. Of course, the secured party cannot foreclose or exercise the debtor/mortgagee's foreclosure or other remedies unless the debtor/mortgagee is entitled to do so under the mortgage. This raises the possibility that the debtor/mortgagee may not be in default under its obligation to the secured party, but the obligor/mortgagor is in default under its note to the debtor/mortgagee. If the debtor/mortgagee is not in default, the secured party cannot foreclose on the mortgage. (The agreement between the debtor/mortgagee and the secured party should address this situation).

Title insurers may have some concerns with respect to these particular revisions to Article 9. For the secured party to have insurable title following a foreclosure, the secured party will need to have a good chain of title to the mortgage. (In some states, a secured party cannot foreclose unless it has a recorded chain of title). This is why the secured party will usually require that an assignment of the mortgage from the debtor/mortgagee to the secured party be properly recorded in the applicable land records at the time of the grant of the security interest in the note to the secured party. If this has not occurred, the debtor/mortgagee may subsequently be unwilling to cooperate in the secured party's request for an assignment to assist the secured party (especially if the debtor/mortgagee is in default under the security agreement or other loan documents).

Sec. 9-607(b) of Revised Article 9 provides a way for the secured party to document its interest in the mortgage in the land records without the debtor/mortgagee's involvement. Under this section, the secured party is authorized to file in the land records a copy of the security agreement and a sworn affidavit, which states that a default has occurred and that the secured party is entitled to foreclose non-judicially. However, some problems exist with respect to this procedure: (1) a conflict may arise with state laws that require an acknowledgment or other conditions to recording a document in the land records (which provisions are usually not found in a security agreement); (2) Neither revised Article 9 nor the Official Comments provide that a memorandum of the security agreement (as opposed to the entire agreement) is sufficient for recording, and there is uncertainty as to whether other loan documents

referenced in the security agreement must also be recorded (most debtor/mortgagees would not want the entire document(s) recorded); (3) a filed security agreement will only (as noted above) establish a chain of title if the debtor named in the security agreement is in fact the mortgagee in the mortgage and the secured party named in the security agreement is the secured party that proposes to foreclose. If there have been further assignments of the note, these further assignments also would have to be documented. See UCC Sec. 9-619 (explaining the transfer statement). As one commentator recently stated, "Title insurance companies presumably will develop underwriting guidelines for determining when a foreclosure by a secured party that has established its chain of title by filing its security agreement is enforceable"; (4) this procedure does not appear to be available in those states that do not permit nonjudicial foreclosure proceedings. See W. Rodney Clement and Baxter Dunaway, "Revised Article 9 and Real Property," 36 REAL PROP. PROB. & TR. J. 511 (Fall 2001).

Sec. 9-109(d)(11) of Revised Article 9 continues to exclude from its coverage "the creation or transfer of an interest in or lien on real property," with certain limited exceptions. This language, but for the exceptions (which don't affect this analysis), is identical to Former Article 9. However, this language is not entirely accurate because, as noted above, Revised Article 9 *does* provide for transfers of mortgages (which clearly are "liens on real property").

If there was intent to transfer a promissory note when an assignment of mortgage was executed, the plaintiff/ lender should prevail. See UCC sec. 3-110(a) ("The person to whom an instrument is initially payable is determined by the intent of the person, whether or not authorized, signing as, or in the name or behalf of, the issuer of the instrument"). Revised Article 9 and Article 3 of the UCC (Negotiable Instruments) allow enforcement when the note has been lost, before or after the transfer to an assignee, or is simply unavailable. See UCC sec. 3-301(iii) (stating that a "Person entitled to enforce" an instrument" includes "a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3-309 or 3-418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument"). Section 3-109(a) provides that a person not in possession of an instrument is nonetheless entitled to enforce it if the instrument was destroyed, lost, or is in the wrongful possession of an unknown person. However, under Sec. 3-309(b) the person seeking enforcement, if not the holder of the note, must prove the terms of the instrument and the person's right to enforcement, and also must provide "adequate protection" (by "any reasonable means") to the debtor/borrower to prevent the debtor/borrower from paying the same debt twice. If there was no intent to transfer, and the assignee of the mortgage was simply a "servicer"/ agent for the holder of the note (which is common in connection with securitized loan transactions), general agency law may still protect the lender. See *also* UCC sec. 3-110(c)(2)(ii) (providing that if an instrument is payable to "a person described as agent or similar representative of a named or identified person, the instrument

is payable to the represented person, the representative, or a successor of the representative”).

In a recent decision by the South Carolina Court of Appeals, *Swindler v. Swindler*, 355 S.C. 245 (S.C. Ct. App. 2003), the court dealt with an issue involving the interplay between Article 3 and Article 9. While acknowledging that the UCC excludes from its application the creation or transfer of an interest in or lien on real estate, the court held that Article 3 clearly applies to negotiable instruments and that the negotiability of a note is not altered by the execution of a related real estate mortgage. The court noted that Article 3 does not distinguish an unsecured note from a note secured by a real estate mortgage and that Article 9 does not exclude a note secured by a real estate mortgage from the application of Article 3. According to the court, “nothing in Article 9 provides a limitation on the applicability of Article 3 to notes secured by mortgages on real estate.” *Id.* at 252. The court stated further that, “Article 9 controls over Article 3 only where some conflict between the applicable provisions of Article 3 and Article 9 exists. Here, no conflict exists because Article 9 does not address the underlying indebtedness of a security interest.” *Id.*

To summarize, under the UCC possession is not an indication of ownership of the note. Recording of collateral assignments is not required under Revised Article 9. Enforcement of the debt without the note is allowable under Article 3. Equitable arguments are available to prevent a borrower from benefiting from the industry's inability to keep track of its documents.

Conclusion

For an analysis and discussion of the nature of the relationship between a lead lender and its participant or participants, the law with respect to the characterization of such a relationship, and the rights and obligations of the respective parties (which topics are beyond the scope of this article), see generally Jones, *Loan Participation, Syndications and Co-Lending*, Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5, 1997), Tab 8; Arnold, *Intercreditor Conflicts Among Loan Participants in the Context of Troubled Debt*, Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5 1997), Tab 7, Part II; Bliwise, Gutmacher, and Peterson, *The Relationship Amongst Co-Lenders -Identifying the Different Policies and Approaches of Co-Lenders Before a Deal Goes Bad*, Finance Topics, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4-5, 1997), Tab 10; Rogers, *Lender Liability Concerns in Participation Agreements*, Commercial Real Estate Finance, American Bar Association (1993), p. 393; Lilly, *Loan Participation From the Participant's Perspective*, Commercial Real Estate Finance, American Bar Association (1993), p. 409; Schiller, *Lindquist and King, Current Issues in Loan Participation and Co-Lending Agreements*, Real Property Programs, Third

Annual Spring CLE and Committee Meeting, American Bar Association, Section of Real Property, Probate and Trust Law (May 7-9, 1992), p. F-3; Billie J. Ellis, Jr., et al., *“Easy Street” or “Risky Business,” – Why Loan Participants Can’t Afford to be Passive Investors*, SC78 A.L.I. – A.B.A. 547, 550 (1998).