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SECURED TRANSACTIONS

The Central Bank Case: Trusting In True Sales of Participations

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Loan participations have long been a staple of the financial markets. Banks and other loan market participants favor them for a myriad of reasons. For example, they allow the originating (or lead) creditor to remove (or derecognize) underlying loans and commitments from its balance sheet, or to avoid exceeding borrowing limits under internal or regulatory guidelines while maintaining client relationships and administrative control. The originator can oftentimes collect arrangement and administration fees without bearing the associated credit risk. On the participant side, they reduce visibility into an institution's exposure to a particular credit and enable diversification of a portfolio without the accompanying administrative burden.

But participating in a loan through an intermediary, in this case an originating creditor, creates its own level of risk, namely the credit risk of the originator. For that reason, the participant often wants assurances that the loans and related collateral have been "sold" to it, and it has full property rights in those assets and not merely the right to proceeds from the lead creditor.

When do loan participation agreements transfer the actual property rights of the originating creditor versus merely a contractual right against the counterparty to proceeds of that property?

When do loan participation agreements transfer the actual property rights of the originating creditor versus merely a contractual right against the counterparty to proceeds of that property? That question was the subject of a decision earlier this year by the Supreme Court of Iowa in the case of *Central Bank and Real Estate Owned, L.L.C. v. Timothy C. Hogan, as Trustee of the Liberty and Liquidating Trust et al.*, 891 N.W.2d 197 (Iowa 2017). Though not groundbreaking, this case provides a thoughtful discussion on this subject, an interesting emphasis on "trust" language, and an opportunity to re-visit current thinking of courts on the issue of when participations are true sales of loan interests.

Case Facts

In the Central Bank case, Liberty Bank had made loans between 2008 and 2009 to Iowa Great Lakes Holding, L.L.C. secured by the real estate and related personal property of a resort hotel and conference center. Liberty entered into participation agreements with five banks covering an aggregate of approximately 41 percent of its interest in those loans.

The participation agreements were identical in terms; each provided that Liberty sold and the

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participant purchased a "participation interest" in the loans. The loans were described in detail and the description included a reference to the real estate mortgage and an "all inclusive" UCC filing.

Iowa Lakes ultimately defaulted on the loans and the collateral was surrendered to Liberty through a nonjudicial voluntary foreclosure procedure which extinguished the mortgage and waived Liberty's right to a deficiency. After Liberty acquired title, it and the participating banks entered into an agreement with a hotel management company. The proceeds from operation of the hotel were deposited in a segregated account, with Liberty and the other banks maintaining a proportionate interest in such amounts.

In October 2013, Liberty sold certain of its assets to Central Bank, including all "loans" in which the borrower's obligations had been extinguished, and conveyed all of its interests in the resort property to a Central Bank affiliate through a quitclaim deed. In 2014, Central Bank filed a declaratory action against Liberty and its five participants seeking a ruling that it owned the resort property free and clear of any interest of the participants.

The participants asserted two sets of arguments. First, they asserted ownership of their proportionate share of the property. Alternatively, they claimed a perfected security interest in such assets, arguing that under Official Comment 5 to UCC §9-109 the participation interests were "payment intangibles," and thus (1) the security interest had automatically attached and was perfected under §§9-203 and 9-309(3), (2) perfection in the right to payment perfected a security interest in the collateral (the mortgage) securing such payment under §§9-203 and 9-308, and (3) the surrendered hotel property constituted "proceeds" under §9-102(64) of that secured payment intangible subject to the lien of the participants.

Ruling on a motion for summary judgment, the district court held that Liberty had transferred an undivided interest in the underlying property, including its mortgage on that property, pursuant to the participation agreements. The Iowa Supreme Court affirmed that summary judgement ruling on appeal, holding that the participation agreement did not transfer to the participants a mere right to share proceeds, but rather all "legal and equitable title" in Liberty's share of the loan and collateral.

The Court's Reasoning

The court started with a somewhat lengthy review of the history of participation agreements, harkening back to imperial Russia. It observed the inconsistent approach of many courts, with some giving presumptive weight to the parties' intent while others focused on the structure of the transaction. It then navigated down the middle, noting that intent is not necessarily determinative ("creatively labelling a goose as a duck may not always work"), and looked to both subjective and objective factors.

The Central Bank court noted preliminarily that the participation interests in this case did not have the kind of explicit language recommended by some commentators (presumably, insufficient sale and assignment language, although the court doesn't make precisely clear what that is). It nevertheless ruled for the participants based on what it referred to as "key markers." First, there was at least some use of sale terminology. Second, the agreements stated that Liberty must hold the loan documents in trust. Third, the participants were given "undivided interests" in the loan documents. In addition, the court noted that the default provisions emphasized that the participants shared ratably in any of the collateral for the loan. Finally, the court noted there were no "disqualifying" provisions that mitigated the credit risk of ownership, such as a put or buy-back provision or a higher rate of interest to a participant.

What's Interesting

Laying a clear roadmap for parties, the court offers its "general proposition" that participants use the language of ownership, undivided fractional interest and trust, as well as avoid "risk dilution devices" to ensure that their interest is treated as an ownership and not a mere loan.

Reliance on those elements is not surprising. What is notable is the degree of weight and attention given to the presence of trust language, using it to distinguish cases with contrary rulings and finding that language requiring the originator to hold documents in trust is the "talisman of a sale of an ownership interest," and again that a "trust relationship negates the finding of a debtor-creditor relationship."

Given the decision of Central Bank, transferees concerned with true sale risk may wish to consider including the trust language found so important by that court.

This emphasis is interesting because trust language is not particularly common in participation agreements and the major loan industry association market standard forms generally do not contain this type of language. Instead, language is included in those forms disclaiming fiduciary or trustee obligations of either party to the other.[1] Given the decision of Central Bank, however, transferees concerned with true sale risk may wish to consider including the trust language found so important by that court. For their part, originators may need to reassess the downside risk of an implied fiduciary duty to hold documents or proceeds on their behalf, or how to effectively limit any such risk.

The court did not address the argument as to whether the participants had a perfected security interest in the loan assets, not unexpected given it concluded that an ownership interest existed in such assets. But the argument that a security interest had attached and was perfected assumed that the participation interests themselves were "payment intangibles" and that there had been a sale of such interests. While the former appears clear, it is difficult to ascertain where, given the facts presented, the latter had occurred.[2]

Conclusion

Not all parties are concerned about the insolvency of the lead counterparty in a participation. For example, participants in loan interests held by FDIC-insured financial institutions, can benefit from a safe harbor under 12 CFR §360.6 of the FDIC Rules and Regulations. Under that provision the FDIC protects counterparties of an insolvent entity if the transfer of the loan assets qualifies (with some limited exceptions) for sale accounting treatment under FAS 166 and is made "without recourse."[3]

For other counterparties, however, the analysis of courts in decisions such as Central Bank continues to be relevant and that decision provides a fairly clear path for participants and originators alike. It will be interesting to see whether and to what extent the decision's strong emphasis on trust language is followed by other courts.

1. Note, however, that although the LSTA participation agreement standard terms and conditions is intended to effect a true sale of the interest in the loan (see, e.g., Sections 4.3, 5.3 and 30 of the June 2017 form), the December 2015 LMA Master Participation Agreement form states expressly in Section 7.1(b) that "the relationship between the Grantor and the Participant under each Risk Participation is that of debtor and creditor."

2. See *Citizens Bank & Tr. Co. v. Sec. First Ins. Holdings (In re Brooke Capital)*, 588 Fed. App'x. 85 U.C.C. Rep. Serv. 2d 349 (10th Cir. 2014), where the court held that the interests of the participants in the payment intangibles under a participation agreement were disguised secured transactions, to be treated as loans instead of sales, and were unperfected since no financing statements had been filed.

3. Under the FDIC rules, "without recourse" means that the participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying obligation.