MEMORANDUM FOR THE FINANCIAL ACCOUNTING STANDARDS BOARD

Re: Participations

We appreciate the opportunity, on behalf of The Loan Syndications and Trading Association (the "LSTA"), to respond to further questions that were raised at the May 25, 2004 roundtable regarding the Request for Information dated April 9, 2004 (the "White Paper") of the staff of the Financial Accounting Standards Board (the "FASB" or the "Board"). This memorandum assumes familiarity with LSTA's letter of May 10, 2004 regarding the White Paper (the "Original LSTA Letter").

This memorandum addresses the questions of what is a "good" (or "true") participation; what property interest is conveyed by a "true participation" and the effect of that conveyance in an insolvency of the transferor; and how that property interest compares to a non-recourse secured loan from the point of view of the transferor, transferee and obligor.

What Is A True Participation?

There are two different ways to define a "true participation": (1) by its consequences (in other words, what are the benefits to the participant of holding a participation that is a "true participation" vs. one that is not); and (2) by its characteristics (what are the features that a participation must have in order for the participant to receive the benefits referred to above). In terms of consequences, a "true participation" is a participation that makes the proceeds of the underlying loan not property of the transferor's estate and as to which the transferor has no equitable right of redemption — i.e., a "true participation" results in a "true sale" of those proceeds. For the most part, this analysis is one of sale versus pledge and thus analyzes factors common to true sale analysis for other asset sales. True sale analysis in the context of participations also can involve whether, if a sale, the mechanics of the sale make it effective against the transferor, its trustee or receiver and its general creditors.

For example, if a promissory note evidences the underlying loan, the question arises whether the lack of delivery or endorsement of the note, and the lack of notice to creditors of the sale of an interest in the note, means the sale is ineffective against the transferor's unsecured creditors because it is not "perfected". As discussed below, some cases rely on an express or constructive trust theory (focusing on "trust" language in the participation agreement) to support their analysis that assets sold under a participation are not property of the estate notwithstanding the lack of delivery or notice mechanics. Under the revisions to the Uniform Commercial Code (the "U.C.C.") made in 2001, however, delivery or endorsement of a note, notice to creditors, or the use of trust language, is no longer necessary (to the extent it might have been prior to
The court in *In re Okura & Co. (Am.) Inc.* generally distinguished a “true participation” from an interbank loan and a syndication as follows:

“Modern multiple lending agreements are often classified as either participation agreements (true participations), interbank loans, or syndication agreements. See *Why Loan Participants Can’t Afford to Be Passive* at 549. 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. See *id.* at 548. As a general rule, the participants do not have privity of contract with the underlying borrower. See *id.* 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. See *id.* at 550.”

What was **not** at issue in *Okura* was whether the participation conveyed an interest in property so that it would be beyond the reach of the transferor and its creditors. In fact the court specifically stated:

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those revisions) in the case of a sale of a promissory note or payment intangible or an interest therein pursuant to a true participation. Specific section references herein to the U.C.C. are to the U.C.C. as in effect in the State of New York.

The impetus for the enactment of Bankruptcy Code Section 541(d), discussed below, was unreported decisions of Bankruptcy Courts that held that loan participations were ineffective against the bankrupt transfers because the transfers had not been recorded and no deliveries or endorsements of notes were made. See *In re Adana Mortgage Bankers Inc.*, 12 B.R. 989, 1006-08 (Bankr. N.D. Ga. 1980), vacated according to the stipulation of the parties, 687 F.2d 344 (11th Cir. 1982).

We will distribute (as a separate pdf file) copies of all cases and other sources cited in this memorandum, in the event the Board or FASB Staff wish to review those sources.

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We begin our analysis with the *Okura* case because the letter of Frederick L. Feldkamp dated May 10, 2004 (the “Feldkamp Letter”) places so much emphasis on that case. It is unclear whether a single decision of a bankruptcy court (albeit a very recent one) deserves so much discussion, although the case is in any event entirely consistent with the conclusions set forth in this memorandum. The Feldkamp Letter also places great weight on the First Circuit’s 1979 brief decision in *Depositors Trust Company of August v. Frati Enterprises, Inc.*, 590 F.2d 377 (1979). In that decision, there is no discussion of the particular terms of the participation (beyond a statement that the lead had the legal power to collect the note and to compromise or adjust its terms), and no discussion of whether an interest in the loan had been sold (other than a statement that the lead did not stand as a trustee for the beneficial owners in such a way as to destroy mutuality). The issue of whether the participation in *Frati* conveyed an ownership interest was not before the court; rather, the court was determining whether the lead or the participant had setoff defenses. The court concluded that the lead had setoff defenses – again, entirely consistent with the conclusions set forth in this memorandum.
"[t]he 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."
249 B.R. at 611. 4

However, a number of other courts have discussed what constitutes a "true participation," as opposed to a loan, in the context of proceedings involving the question of whether a participant is an owner of an asset sold to it, or instead an unsecured creditor of the transferor. We first discuss cases under the Bankruptcy Code (the "Code"), and then cases under the Federal Deposit Insurance Act ("FDIA").

**Code**

The cases involving whether a participation is a sale of an asset in the event of the transferor's Code proceedings are almost all under Section 541(d) of the Code. Section 541(d) provides that:

"Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."


There are a number of cases decided under Section 541(d) and this memorandum does not attempt to analyze in detail all of those cases. Some of those cases do not involve participations, but "greater" transfers than a typical loan participation where no "mechanics" are

Interestingly, the Frist decision has rarely been cited by later courts in connection with its decision on participations.

4 Here, the Okura court was discussing Savings Bank of Rockland County v. FDIC, 668 F. Supp. 799 (S.D.N.Y. 1987), vacated according to the stipulation of the parties, 703 F. Supp. 1054 (S.D.N.Y. 1988), stating that the issue in Okura — whether a participant has a right to assert a claim against the obligor in bankruptcy — was a "very different legal issue" from the issue facing the Rockland County court — whether a participation was a sale vis-à-vis the transferor bank. Okura, 249 B.R. at 611. We discuss Rockland County in more detail below.

The Okura court certainly did address whether the participation in that case was an "assignment" or a "joint tenancy" for purposes of the question of whether the participant obtained a direct claim against the obligor. We discuss those points below.
undertaken to transfer the loan; many of those cases involve the question of whether a "constructive trust" (a remedy under state law) can be imposed on property and have nothing to do with participations, and many of those cases involve a fraudulent transferor. Furthermore, some of those cases limit their holdings to transactions involving the secondary mortgage market.

Even if one limits these holdings to the context of participations in the secondary mortgage market under Code Section 541(d), they are a useful description of how courts think about participations. One relatively recent case, held as follows:

"We adopt Yale's holding. A true participation agreement is one [in which]: a) money is advanced by participant to a lead lender; b) a participant's right to repayment only arises when a lead lender is paid; c) only the lead lender can seek legal recourse against the borrower; and d) the document is evidence of the parties['] true intentions."

The court had previously indicated that:

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See, e.g., Bear v. Coben (In re Golden Plan of Cal.), 829 F.2d 705 (9th Cir. 1986) (transfers of mortgage notes to third party servicer were sales and not loans).

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See, e.g., XL/Datacomp, Inc. (In re Omegas Group), 16 F.3d 1443 (6th Cir. 1994) (541(d) does not allow constructive trust to trump usual principles of bankruptcy sharing). But see In re Neijberger, 934 F.2d 1300, 1302 (3rd Cir. 1991).

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See, e.g., Beutel v. Joans (In re Inv. Sales Diversified), 38 B.R. 446 (Bankr. D. Minn. 1984); see also Willson v. MLA, Inc. (In re Ascot Mortgage, Inc.), 153 B.R. 1002 (Bankr. N.D. Ga. 1993) (Section 541(d) does not apply where transferor does not retain title for purpose of servicing).

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The court's reference is to In re Yale Express Sys., Inc., 245 F. Supp. 790 (S.D.N.Y. 1965), a case which held - like Okura - that a participant does not have a right of setoff against an obligor.

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In re Coronet Capital Co., 142 B.R. 78, 82 (Bankr. S.D.N.Y. 1992). The Coronet Capital court found that the participation in issue was not a true participation but instead a disguised loan, as the transferor guaranteed the transferee against all risk of loss. Although Coronet Capital involved only the question of whether the participant was subject to the automatic stay, many of the true participation cases involve the more significant (from the participant's perspective) question as to whether, if the participant has not purchased an asset but instead made a disguised loan, the participant has a perfected security interest in the asset. Ironically, the U.C.C. often requires more action to be taken to perfect a security interest in an asset than a sale of an asset. In the case of a promissory note, delivery or filing is generally required to perfect a security interest, and filing is required to perfect a security interest in a payment intangible. U.C.C. §§ 9-310, 9-312, 9-313. As discussed in footnote 18 below, no filings are necessary to perfect a sale of a promissory note, a payment intangible or an interest therein.
The relationship between a lead lender and a participant is characterized as debtor and creditor if the participation is in fact a loan. The factors indicating an intention to create a loan instead of a participation include: 1) guarantee of repayment by the lead lender to a participant; 2) participation that lasts for a shorter or longer term than the underlying obligation; 3) different payment arrangements between borrower and lead lender and lead lender and participant; and, 4) discrepancy between the interest rate due on the underlying note and interest rate specified in the participation.

A number of courts analyzing participations in the context of Code Section 541(d) have employed this distinction—also drawn in Okura—between a "true participation" and a loan. Most have found disguised loans, but a few have found "true participations." A few other Code cases that pre-date the enactment of Section 541(d) help illuminate what is a "true participation." In re Alda Commercial Corp., 327 F. Supp. 1315 (S.D.N.Y. 1971), involved a loan participation where the court held that the participant was merely a general unsecured creditor of the transferor. The court emphasized the lack of notice of the participation to creditors of the transferor, and concluded that the transferor was not an agent for...
the transferee and that there was no segregation of funds and none was contemplated.\textsuperscript{14} The Aida court distinguished a Second Circuit case, Stratford Financial Corp. v. Finex, 367 F.2d 569 (2d Cir. 1966), in which the Second Circuit held that a loan participation created a trust arrangement.\textsuperscript{15}

These cases, together with the cases under the FDIA described below, could be interpreted to require that in a “true participation” the transferor must expressly act as agent for the transferee, and hold any assets “in trust” for the transferee. Even if the transferor does not hold proceeds “in trust” for the transferee, commingling of the proceeds may be incompatible with a “true participation.”\textsuperscript{16}

We believe, however, that recent revisions to the U.C.C. relax the potential requirement that the transferor expressly hold assets “in trust.”\textsuperscript{17} The courts that required, or relied on, a trust arrangement for a participation to constitute a sale seemed principally to have been concerned with the lack of mechanics involved in a typical loan participation where the only evidence of the participation is the participation agreement itself. The revisions to the U.C.C. that became effective in 2001 clearly provide that no action is required for the “perfection” of a sale of an interest in a promissory note or payment intangible.\textsuperscript{18} Although we have found no case on point

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\item See also Pan Am. World Airlines, Inc. v. Shulman Transp. Enters., Inc. (In re Shulman Transp. Enters., Inc.), 744 F.2d 294 (2d Cir. 1983) (bankrupt not an agent when it commingled funds and its collection activities not subject to principals’ direction and control).
\item The agreement in Stratford included language that, although the loan would be conducted solely in the name of the transferor, all notes would be held “in trust”. The court also found that there was very limited commingling of the proceeds of the notes. Accordingly, the court allowed the participant to retain proceeds that the transferor had paid to it after bankruptcy.
\item See also Hatoff v. Lemons & Assocs., Inc. (In re Lemons & Assocs., Inc.), 67 B.R. 198 (Bankr. D. Nev. 1986), in which the court relied on Section 541(a), rather than Section 541(d), and held that the participations in that case created trusts in which the participants held equitable interests that were not property of the estate, but that, due to the seller’s fraud, the participants could not trace their interest sufficiently to overcome a pro rata distribution to all creditors.
\item Even if commingling is not incompatible with a true participation, a transferee may only have an unsecured claim for commingled funds owned by it because of its inability to trace those funds.
\item We understand that Mr. Feldkamp has stated that if a bank transferor declares itself a trustee, and endorses a note to itself as trustee, those steps would be sufficient to have a “true sale” under Statement 140. While we agree with that view, as described below, we do not believe that such steps are necessary. Even if the U.C.C. revisions do not eliminate any “trustee” requirement, the case law prior to the U.C.C. revisions would only possibly require, in the case of a non-bank, an acknowledgment that the transferor holds the property in trust, and would not require an endorsement of any note. The pre-U.C.C.-revision bank insolvency cases might require greater evidence of a trust relationship, but would also not require an endorsement of any note.
\item As noted in the Original LSTA Letter, a loan asset is either a “promissory note” or a “payment intangible” under the U.C.C.
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U.C.C. Section 9-309 provides that a sale of a promissory note or a payment intangible is “automatically perfected” – i.e., no action beyond the sale agreement is required to make the transfer effective against creditors of the transferor and a bankruptcy trustee of the transferor.
interpreting these very recent provisions, we believe that they provide the basis to conclude that specific "trust" language is unnecessary for a "true participation." 19

FDIA Cases

There have been very few cases in which the FDIC (or RTC or FSLIC) has challenged a loan participation as not giving the transferee ownership rights (as distinguished from cases involving the relative priority of participants and obligor and transferor setoff rights). 20

Official Comment 5 to U.C.C. Section 9-109 provides in pertinent part that "a 'sale' of an account, chattel paper, a promissory note, or a payment intangible includes a sale of a right in the receivable, such as a sale of a participation interest." The Feldkamp Letter asserts that "[a]fter reciting that a 'sale' of a loan 'includes a sale of a right in the receivable, such as a participation interest,' the official comment to the new U.C.C. reiterates that whether a particular transaction is, in fact, a sale, remains a matter of case law:

[Neither this Article nor the definition of 'security interest' ...delineates how a particular transaction is to be classified. That issue is left to the courts.]

The excerpt from Official Comment 4 to U.C.C. Section 9-109 quoted in part in the Feldkamp Letter reads in its entirety as follows:

"Although this Article occasionally distinguishes between outright sales of receivables and sales that secure an obligation, neither this Article nor the definition of 'security interest' delineates how a particular transaction is to be classified. That issue is left to the courts." (citations omitted)

The entire comment to U.C.C. Section 9-109 is included in the source materials attached hereto, but it is clear to us that Comments 4 and 5, when read together in their entirety, mean that, first, whether a transaction is a sale or a secured transaction is left to the courts; and, second, a sale of a participation interest can be a sale even though it is only a right in a receivable and not the entire receivable.

See, e.g., Terry Anderson et al., Attachment and Perfection of Security Interests Under Revised Article 9: A 'Nuts and Bolts' Primer, 9 Am. Bankr. Inst. L. Rev. 179, 184 (2001): "[S]ales of most kinds of rights to payment will require filing [a U.C.C.-1 financing statement], while sales of payment intangibles, including loan participations, will be perfected upon attachment."

Although one could argue that, in light of the U.C.C. provisions, the transferor would not even have to act on behalf of the participant in collecting proceeds from the obligor, this firm would not - in the absence of case law - be willing to render a "would"-level opinion without a statement in the participation agreement requiring the lead to act "on behalf of" the participant (or similar or stronger words). Other counsel might consider the statutory changes sufficient - even in the absence of case law - to render such an opinion without such language.

See, e.g., Sav. Bank of Rockland County v. FDIC, 668 F. Supp. 799 (S.D.N.Y. 1987), vacated according to the stipulation of the parties, 703 F. Supp. 1054 (S.D.N.Y. 1988). See also, Guaranty Savings and Loan Association v. Ultimate Savings, 737 F. Supp. 366 (W.D. Va. 1990), involved the question of whether a participant had a priority claim and could trace proceeds of notes the subject of a participation. The court found that the participation arrangement created a fiduciary relationship between the transferor and transferee (the transferor agreed to act "as trustee") and allowed the participant to trace the proceeds and have a priority claim thereto. Although the court described this as a "secured claim," it is clear from the case that the claim was instead an ownership claim. Although not entirely clear, it would seem that the reason that the FDIC disputed the participant's claim revolved around whether the particular property in that case was traceable to the participated loans. See also Empire State Bank v. Citizens State Bank, 932 F.2d 1250 (8th Cir. 1991). Empire State also involved a claim to proceeds relating to a participated loan (in that case, amounts recovered by the FDIC as receiver under a banker's blanket bond and an excess
Rockland County is a decision that was vacated after the parties settled their dispute. Even though Rockland County did not in our view involve a true participation, because the selling bank was obligated to repurchase the loans in the case of default, the District Court held that the proceeds of the loans were not assets of the selling bank's estate:

“Although non-binding authority weighs against determining that the transaction at issue here was a purchase and sale, on equitable grounds a distribution from the receivership estate in priority to the general creditors will be awarded in the amount of [80% of all loan collections].” Rockland County, 668 F. Supp. at 808.

The court focused on the intent of the parties – the use of purchase and sale language – as well as the prompt remittance by the transferor prior to receivership of proceeds of the loans. The court also seemed to be quite influenced by the FDIC’s practice of describing participations sold by it in loans acquired through receiverships with recourse as purchases and sales.

The Rockland County case thus does not shed much light on what is a “true participation.” Notably, however, the court recited that:

“...The FDIC does not contest the proposition that a valid loan participation creates an ownership interest in the participant, in this case Rockland. See FDIC v. Mademoiselle of California, 379 F.2d 660, 664 (9th Cir. 1967); InterFirst Bank Abilene N.A. v. employee dishonesty blanket bond). The case was a jurisdictional dispute and did not involve an adjudication of any “true sale” issues.

The participation in Rockland County would not fall within the FDIC’s rule on participations and securitizations, 12 C.F.R. 360.6, due to the recourse feature of the participation. In this regard, the Feldkamp Letter asserts that the FDIC rule does not apply to a participation where there is no transfer or assignment, and since a participation that does not involve an assignment cannot be a sale, the rule does not apply to a participation where there is no assignment. We believe this interpretation – which would render the rule almost meaningless as to participations – is incorrect. Rather, as described below, a true participation conveys an ownership interest in a loan asset, and is thus a “transfer” within the meaning of the rule.

The participant held an 80% participation.

The fact that the FDIC did not contest the proposition that a “valid” loan participation (which we take to mean in this context one that is sold without recourse) creates an ownership interest is entirely consistent with the FDIC correspondence on this issue as well as the cases discussed below. See Letter from Lawrence Bates, Counsel, FDIC (October 23, 1984), or 1984 Interp. Ltr LEXIS 20, in which an FDIC attorney states that “[i]t is my understanding that a loan participant will receive its pro rata share of any payment made by a debtor which augments the receivership estate.” The few cases in which the FDIC challenged a participant’s rights to actual proceeds of a loan in a participation sold without recourse all seemed to involve tracing issues.

Mademoiselle is the seminal case involving loan participations and the effect of setoff rights on a participant. As described in the Original LSTA Letter, the court in Mademoiselle held that the participation did not cut off the obligor’s right of setoff and that the participant only had an unsecured claim for the

Rockland County, 668 F. Supp. at 804 (citations in original).

In Northern Bank v. FDIC, the Nebraska Supreme Court addressed whether a Certificate of Participation that did not clearly express an intent to sell an asset (it simply stated that the participant was “entitled to participation” in a loan) and which did not contain express trust language (although it did indicate that the lead was to hold the loan “for its benefit and the benefit of the holders”) effectuated a sale, even though legal title remained in the lead.

The cases addressing the relative rights of participants and obligor and transferor setoff, and in particular the Penn Square cases, may be relevant to the question of what constitutes a “true participation”.

The Penn Square cases, as noted in the Original LSTA Letter, are not particularly well-reasoned and in many cases are inconsistent and quite confusing. However, they clearly stand for the proposition that a participation does not cut off obligor or transferor setoff rights (in the absence of enforceable waiver). Beyond that, one can draw some inferences as to what is a “true participation” for purposes of whether a participation conveys a property interest in the underlying loans.

amount set off because it could not trace any augmentation of the selling bank’s estate. The Ninth Circuit stated that “[If Mademoiselle had made a specific payment on the note..., this case would come within that rule [that an assignment of payments to be made in futuro passes legal title in the proceeds to the assignee].” 379 F.2d at 665. This statement is arguably dicta, and the Mademoiselle case does not shed much light on what is required for a “true participation.” We discuss Mademoiselle in detail below in the context of the nature of the property interest transferred by a participation.

InterFirst-Abilene involved the question of whether a participant could offset amounts owing to a failed bank against the failed bank’s contractual indemnity obligations relating to loan participations that had been fraudulently sold by it. Although this question is not relevant to the issues discussed in this memorandum, it is useful to note that the FDIC, which had initially “retaliated” by not passing through the participant’s share of proceeds, did not appeal the judgment of the District Court requiring it to do so. InterFirst Bank Abilene N.A. v. FDIC, 777 F.2d 1092, 1094 (5th Cir. 1985).

The Columbia Pacific case is described in footnote 13 above.


Id. at 466. The court further held that the participant could trace the proceeds of the loan, notwithstanding the FDIC’s arguments to the contrary.

In Chase, Hibernia and Northern Trust, apparently only the participation certificates were in evidence before the courts; they were very short-form; did not evidence a clear intent to sell any property interest; were non-assignable; and could be repurchased at par plus accrued at any time. The participation certificates obligated Penn Square Bank to exercise the same care in protecting the participants' interest in the loans as it did to protect its own interests. In Seattle-First, on the other hand, the court examined a detailed participation agreement that evidenced an intention to sell a property interest; that constituted the seller a "trustee"; that restricted the seller from modifying the loan documents; and that required the seller to mark all notes to show the participant's interest. Although the Seattle-First court held that this participation was insufficient to cut off obligor or transferor setoff rights,30 and held that the participation agreement was ambiguous as to whether it conveyed any property interests, it is clear that the Seattle-First participation agreement was at least a "better" participation agreement than those in Chase, Hibernia and Northern Trust.

So far, we have focused on defining a true participation in terms of its consequences. Turning now to a definition in terms of characteristics, this firm would define a "true participation" as one in which:

- There is no guarantee of repayment by the lead lender to a participant or other recourse inconsistent with a sale;
- The participation lasts for the same period of time as the underlying obligation;
- The participation provides for a pure pass-through of amounts paid by the obligor, less any spread representing servicing or other compensation or a retained interest;
- The participation purports to be a sale of a property interest;
- The seller is not permitted to commingle for any significant period of time collections on the loans;
- The seller agrees to act on behalf of the participant with respect to its holding of any notes or collateral therefor, and in holding any collections on the loans; and
- The seller agrees to service the loans under a standard that does not give it unfettered discretion as to all matters.31

30 "The Court concludes as a matter of law that the challenged offsets were proper, notwithstanding any property or trust interests conveyed to SeaFirst, because mutuality between Penn Square and the borrowers survived the participation agreement." Seattle-First, 619 F. Supp. at 1358. The judge in the concurring opinion in Hibernia came to the same conclusion on the basis of the much more sparse record in that case.

31 We do not address in this memorandum the rights between multiple participants in a single loan (including the rights of a lead lender if it holds a majority interest in the loan). Whether such arrangements would, in practice, give "too much" discretion to a lead lender would need to be examined on a case-by-case basis.
A "true participation" would not, however, require a transfer or endorsement of any note, notice to any obligor, explicit "trust" language, and could exist even if the underlying loan had transfer restrictions.32

It must be emphasized that, as is the case with true sale issues generally, different counsel will place different weight on the various factors set forth above33 and, especially because the language and circumstances of various participation arrangements vary from participation to participation, there is no "one size fits all" answer as to what constitutes a "true participation."

What Property Interest Is Conveyed By A True Participation?

A discussion of the issue of what property interest is conveyed by a true participation is complicated because courts have used different nomenclature in describing that property interest.34 It is perhaps easiest to begin the discussion with an analysis of what is not conveyed.

As discussed in the Original LSTA Letter and in the Feldkamp Letter, a true participation does not convey a right to directly enforce the underlying loan.35 A related point is that the participation may not convey a right to the transferee to exercise setoff defenses against the obligor,36 and, unless the subject of an enforceable waiver, the transferor can continue to exercise setoff defenses against the obligor.37

32 See footnote 38 below regarding transfer restrictions.

33 In particular, counsel may have differing views as to how much discretion the lead bank can be given as servicer and as to how much recourse is inconsistent with a sale.

34 See, e.g., Asset Restructuring Fund, L.P. v. Liberty Nat'l Bank & Resolution Trust Co., as Receiver, 886 S.W.2d 548, 554, n.5 (Ct. App. Tex. 1994) ("We decline to settle the exact type of interest a participant bank has in the underlying collateral of a participated loan. It is sufficient for us to recognize that the RTC possessed at least an equitable ownership interest in the collateral securing the Pond Springs loan pursuant to the Participation Agreement . . . .")

35 See, e.g., Okura and cases cited therein.

36 As discussed in the Original LSTA Letter, there are arguments that provisions of the U.C.C. enacted since Okura would change this result. As stated at the May 25, 2004 roundtable discussion, however, we do not believe that, in the absence of case law, there is strong enough support for this conclusion to render a "would"-level opinion on the matter. We therefore assume for purposes of this memorandum that a true participation does not transfer such setoff defenses to the transferee.

We note that there are a number of techniques to clearly cut off transferor setoff rights – including waivers and declarations of trust – that go beyond what we consider to be necessary in a "true participation."

37 See Okura and cases cited therein. See also Original LSTA Letter.
The fact that these rights are not transferred does not mean that there is no transfer whatsoever—it just means that these rights are not transferred. If no rights were transferred, then the transferee would not have a priority claim in the insolvency of the transferor, and as set forth above, there are numerous cases where a participant has enjoyed this priority in the proceeds of the participated loan. We now examine those cases and cases relating to setoff to determine precisely what property interest is transferred. As in the prior analysis, we first analyze the Code cases, and then the FDIA cases.

**Code Cases on True Participations**

In *Columbia Pacific*, the court found that the participation agreement (which provided for the seller to hold the assets "in trust") created an express trust under the laws of Washington State, and (without relying on the specific carve-out in 541(d)) stated that the bankruptcy trustee holds trust property subject to the interest of the beneficiary. *Columbia Pac.*, 20 B.R. at 263. Thus, the participant's interest was an equitable interest in trust property held by the seller as trustee.

A pre-Section 541(d) case involving participations, *Stratford*, also found a trust, *Stratford*, 367 F.2d at 571, and implicitly found that the participant's interest was not property of the estate because it was an equitable interest in trust property held by the seller as trustee.

**Other Code cases**

As noted above, *Southern Industrial* involved the question of whether an attachment creditor could attach mortgage notes the subject of participations. In answering this question in the negative, the court found that the seller "had neither a beneficial nor equitable interest in the six notes when the respective garnishment writs

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38 The distinction between ownership rights and enforcement rights in an asset is highlighted by U.C.C. provisions that became effective in 2001. Under Section 9-408 of the U.C.C., a provision in a promissory note or payment intangible (among other assets) that restricts assignment or transfer of the promissory note or payment intangible is ineffective as between the transferor and the transferee, but the assignment, among other things, "(1) is not enforceable against the person obligated on the promissory note or [payment intangible]; (2) does not impose a duty or obligation on the person obligated on the promissory note or [payment intangible]; [and] (3) does not require the person obligated on the promissory note or [payment intangible] to recognize the [sale], pay or render performance to the [transferee], or accept payment or performance from the [transferee] ...." U.C.C. § 9-408(c). Thus, state law makes clear that a transfer can be effective between the transferor and the transferee, even though the transferee cannot directly enforce the asset against the obligor.

39 Statements in the Feldkamp Letter that a participant is for all purposes an unsecured creditor are not correct.

40 As noted above, most of the Section 541(d) cases found that there was not a true participation due to recourse. They are therefore not enlightening on the question of what property interest is transferred by a true participation.
were served. [The seller] merely held legal title to the notes when the writs were served and could have enforced payment only as trustee for the benefit of the participants.\(^{41}\)

Similarly, the Tenth Circuit in McVay, in holding that participants’ rights were superior to the rights of a judgment creditor, held that “absent some defect in the transaction, the participating lenders, as owners, would possess the entire equitable interest in the note and mortgage associated with the loan”\(^ {42}\) and later disagreed that the participation agreement did not establish a valid trust relationship under Wyoming law.

Okura has a lengthy discussion of what the participation in that case was not; it was not a partial assignment; it was not a joint tenancy in common; and it did not give the participant setoff rights against the obligor. (There is no indication that the participant in Okura argued that the lead was a trustee for the participant as owner of an equitable interest.) Although the Okura court expressly stated that it was not addressing the “very different” legal question of whether a participation transfers rights vis-à-vis a lead, it did state in dicta that:

“[t]he 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.” Okura at 608.

Furthermore, the court stated that the “sale and transfer” clause in the participation agreement in issue “appears to serve the more limited purpose [than a partial assignment] of expressing that Fuji was conveying to BTM a 22.5 percent interest in 1) any proceeds from the loan and 2) any liabilities that may arise out of the underlying loan.” Id. at 604.

Thus, although speculative, perhaps the Okura court might have characterized the “undivided interest” as being an interest in the proceeds of the loan.

Although In re Drexel Burnham Lambert Group Inc., 113 B.R. 830 (Bankr. S.D.N.Y. 1990) did not involve a typical participation arrangement (and was so distinguished on that basis by the Okura court), it did have a lengthy discussion of typical participations that is informative. The court stated:

“Participants in a loan participation agreement, even where there is but one single promissory note held by the lead bank in its own name, are recognized as holding partial ownership interests, in the amount of their ratable shares, of a fund received by the lead bank as agent for all the participants, including itself, in collecting the


\(^{42}\) McVay v. Western Plains Service Corp., 823 F.2d 1395, 1399 (10th Cir. 1987).
loan. [Citations omitted.] The lead bank, by participating the loan, assigns, transfers, and conveys an undivided percentage ownership interest in the collateral for the participated loan to the participant. It holds the funds it collects by way of repayment of the loan for distribution to the participating banks according to their percentage ownership interest. Accordingly, the loan participants are entitled to their shares as beneficiaries of a trust.”

"The relationship is not that of debtor and creditor. In cases where the lead bank is an agent of the participating banks, the lead bank is an 'agent-trustee' if it receives title to the funds or a bailee, who holds the funds in trust without the attendant fiduciary responsibilities, if it does not have title but mere possession of the funds. Acting as a collection agent, the lead bank is 'not a debtor of the principal, unless the principal manifested an intention that the agent should be entitled to use the money as his own.'"

Id. at 844 (citations omitted).

According to this description, the lead bank is a trustee or other agent, and the participants have an ownership interest in the proceeds of the loan collected by the lead bank.

FDIA Cases

There are a number of bank insolvency cases substantively addressing participations outside of the context of setoff rights. In Rockland County, the court found that the participant had an ownership interest in the proceeds of the subject loan. In Guaranty, the court determined that the participant had a trust interest in property traceable to the participated loan. In Mt. Pleasant, the Supreme Court of Iowa ruled in a case where creditors challenged the FDIC's payment as receiver of proceeds of loans to loan participants. The court, citing Mademoiselle, held that the preference given to the loan participants, as owners of the payments received from the obligors, was appropriate. In Northern Bank v. FDIC, the Supreme Court of Nebraska held that the

43 Some of the cases cited involved participations where there was no transfer or endorsement of any note; some of the cases did involve transfers or endorsements.

44 The court noted that "[a]s to this general rule there is little debate." Id. at 844 n.16.


46 Id. at 556.

47 Northern Bank v. FDIC, 496 N.W.2d 459 (S. Ct. Nebraska 1993). See also Holcomb State Bank v. FDIC, 536 N.E.2d 453 (Ct. App. III. 1989) (although payment to purchase underlying loan not payable to participant, court stated that in related proceedings, a federal court had found that the participation agreement created ownership interest in underlying assets).
participant had an interest in a constructive trust, and that the participation effectuated a sale. The court stated:

"However, legal title to the promissory notes and related documents remained in [the lead bank], who as lead bank acted as an agent for [the participant] in servicing the loan; as such, [the lead bank] served merely as a conduit between the [obligor] and [the participant]. As a consequence, the repayments never became assets of [the lead bank]; it merely held the repayments in constructive trust for the benefit of [the participant]."

In Mademoiselle, the Ninth Circuit held that, notwithstanding a participant's ownership interest, it took subject to obligor setoff rights, and, moreover, there was no augmentation in the estate that the participant could trace. The court stated (arguably in dicta) that:

"An assignment of payments to be made in futuro, usually in the form of accounts receivable, is held to pass legal title in the proceeds to the assignee. The assignor becomes a collection agent for the assignee so that upon the insolvency of the assignor, the proceeds of the accounts in the hands of the receiver are the property of the assignee."

379 F.2d at 665 (citations omitted).

"If Mademoiselle had made a specific payment on the note in the amount now claimed by Union, this case would come within that rule. The difficulty is that there was [no] such payment coming in to SFNB or the receiver, but only an offsetting against the indebtedness of previously established credits. Such an offset is insufficient to establish a fund which Union can claim as its own."

379 F.2d at 665.

The Mademoiselle court, therefore, seemed to view the participant as having legal title in proceeds, held by the lead as an agent.

The Penn Square cases are confusing. As noted above, only Seattle-First involved a detailed participation agreement. In Chase, the court held that Penn Square "did not assign, either in whole or in part, the participated loans or the collateral securing such loans to Chase" (focusing in particular on Penn Square's retention of the notes and collection rights). 554 F. Supp at 256. It found that, unlike in Mademoiselle, Chase was not an assignee and only had contractual rights against Penn Square. (Again, the participation certificate in evidence did not express any intention to sell an asset.)

The facts of the case make clear that the FDIC passed through all traceable proceeds of the loans to Chase. 

48 Id. at 466.

49 Chase, 554 F. Supp. at 253. It would not have done so if there was not a sale of an interest in the loans by way of the participation. See Hibernia, 733 F.2d at 1407 ("The FDIC, when acting as a receiver for an
In **Hibernia**, the Tenth Circuit held that the participations did not transfer "ownership," but were nothing "other than 'assignments without recourse' coupled with an agency." 733 F.2d at 1407. We do not understand how an assignment without recourse coupled with an agency does not transfer a property interest.\(^{50}\) Again, the only item in evidence was a participation certificate that did not purport to sell an interest in the loans. Interestingly, one of the Circuit Court judges concurred in part and dissented in part, stating that "I am satisfied that the participations constitute assignments of ownership of the loans to Hibernia to the extent of the percentages it acquired." Id. at 1410.\(^{51}\)

In **Northern Trust**, the court, again faced with just a participation certificate that did not purport to sell an interest, relied on Hibernia and came to the same conclusions as the Hibernia court.

In **Seattle-First**, the court was faced with a much more detailed participation agreement that purported to sell an interest in the underlying loan and constituted Penn Square the "trustee" for Seattle-First. The court found that the participation agreement was ambiguous on whether a property interest or a trust interest was conveyed, and held that:

"Arguably, the offsets impaired Seafirst’s property rights in the expected repayment of its share of participated loans. However, the 'ownership interest' acquired by Seafirst through participation was merely its share of an expectation generated, managed, enforced and collected by the lead bank, Penn Square. Seafirst took this interest subject to the borrower’s and the bank’s rights of offset. Absent terms in the participation agreement barring the assertion of such offsets, they remained enforceable by either the borrower or the bank.”

619 F. Supp. at 1358.\(^{52}\)

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\(^{50}\) See Drexel at note 15 (criticizing Hibernia).

\(^{51}\) Notably, the lower court in Hibernia had viewed, in the context of another loan pool, the right of Hibernia to purchase outright certain loans as a significant factor in determining that the purchaser did not take subject to offset rights.

\(^{52}\) The court’s comment about the ability of either the bank or the borrower being able to waive offset rights is interesting in light of the FDIC’s statements to the effect that, at least as to $100,000 per borrower, the bank’s offset rights cannot be waived. See Original LSTA Letter in this regard.
These cases do not shed much light on the nature of a property interest conveyed by a participation – in three out of four, involving participation certificates that did not express an intention to sell any interest, the court held that none was conveyed; in Seattle-First, the court was skeptical that a property interest was conveyed, even though the participation was well-drafted and in our view a true participation. To the extent that an interest was conveyed, it was a property interest, or a trust interest, and was only an interest in proceeds of the loans.

As discussed above, amendments to the U.C.C. in 2001 help to clarify the situation. Under the U.C.C., a loan asset is either a promissory note or a payment intangible, and the Official Comment to the U.C.C. makes clear that a partial interest in a promissory note or payment intangible, such as a loan participation, can be transferred. No trust relationship is necessary.

We would thus answer the question of what is transferred by a true participation as follows:

It does not transfer the right to enforce the loan directly. It may not transfer setoff rights in connection with the loan. It does transfer a right to the proceeds of the loan.53 The right to proceeds is an ownership right in the loan that is prior to the claims of creditors of the transferor generally, and the transferor would have no right of redemption with respect to such proceeds.

As stated in the Original LSTA Letter, this and other firms have rendered "would"-level true sale opinions as to "true participations," to the effect that the participant's share of proceeds of the participated loan are not property of the bankruptcy or receivership estate.

Comparison To Non-Recourse Secured Loan

At the Board's request, we now analyze the differences between a "true participation" and a non-recourse secured loan. To present our analysis as clearly as possible, we employ the following terms: in the context of a "true participation", we refer to the transferor as the "transferor/seller" and the transferee as the "participant"; in the context of a non-recourse secured loan we refer to the transferor as the "transferor/borrower" and the transferee as the "transferee/lender"; and, in each case, we refer to the obligor as the "underlying obligor". We have made the following assumptions and use the following additional terminology in the case of a non-recourse secured loan. We assume that the loan made by the transferee/lender to the transferor/borrower is secured by an interest in the "underlying asset" perfected under applicable law (e.g., through the filing of a U.C.C. financing statement). We have assumed that the underlying asset does not contain any transfer restrictions; that it is not evidenced by a negotiable instrument negotiated to the transferee/lender; and that no

53 As set forth in the Original LSTA Letter, the exercise of obligor or transferor setoff rights does not result in any proceeds, thus potentially impairing a transferee's rights.
notice is given to the underlying obligor prior to the transferor/borrower’s insolvency proceedings. 54

The basic distinction between a true participation and such a non-recourse secured loan relates to the rights of the transferor/borrower and the transferee/lender. There would be little distinction as to the rights of the underlying obligor.

Transferor Rights

True Participation: As stated above, the transferor/seller would continue to enforce the underlying asset and may continue to have setoff rights (in the absence of an enforceable waiver). The transferor/seller would have no ownership interest in the proceeds of the underlying asset sold to the participant.

Non-Recourse Secured Loan: The transferor/borrower would continue to enforce the underlying asset and would continue to have setoff rights (in the absence of an enforceable waiver), prior to its default to the transferee/lender. The transferor/borrower would have an ownership interest in the underlying asset pledged to the transferee/lender.

Because, in the case of a participation, the participant’s share of the proceeds of the underlying asset would not be property of the estate, they would be payable in full to the participant, and would not be subject to the claims of the creditors of the transferor/seller generally. The transferor/seller would have no right of redemption in respect of the participant’s share proceeds of the underlying asset. Because, in the case of a non-recourse secured loan, the transferor/borrower would have an ownership interest in the underlying asset, the transferor/borrower would be entitled to the proceeds of the asset in excess of the obligations secured by the asset. The transferor/borrower would have a right of redemption with respect to the underlying asset.

Participant and Transferee/Lender Rights

True Participation: As stated above, the participant would not have a right to enforce the underlying asset directly and would not have setoff rights against the underlying obligor. The participant would have an ownership interest in its share of the proceeds of the underlying asset.

Non-Recourse Secured Loan: The transferee/lender would not have a right to enforce the underlying asset directly until a default by the transferor/borrower. The transferee/lender would not have setoff rights against the underlying obligor prior to a default by the transferor/borrower. The transferee/lender would have a security interest in the underlying asset.

54 Varying these assumptions might affect the ability of the transferee/lender to enforce the underlying asset directly against the underlying obligor, the acquisition by the transferee/lender of setoff rights and the underlying obligor’s setoff rights, but they would not affect whether the transferor/borrower owned the underlying asset or had a right of redemption in respect of the underlying asset.
Although, in the case of a participation, the proceeds of the underlying asset would not be property of the estate, the participant’s right to obtain the proceeds would be subject to the automatic stay under the Code (the stay applies not only to obtain property “of” the estate, but also property “from” the estate). During the pendency of the stay, however, the transferor/seller would not be entitled to use, sell or lease the property, because it would not be property “of” the estate and, ultimately, the participant would be entitled to its share of all of the proceeds. Because, in the case of a non-recourse secured loan, the transferee/lender would have only a security interest in the underlying asset, the transferee/lender’s rights would be subject to the automatic stay; it would not be entitled to any excess over the amount of the secured obligation; and the transferor/borrower could potentially use, sell or lease the asset, subject to giving the transferee/lender “adequate protection.”

Rights of the Underlying Obligor

True Participation: The underlying obligor would continue to have offset rights against the transferor/seller absent a waiver by the underlying obligor.

Non-Recourse Secured Loan: The underlying obligor would continue to have offset rights against the transferor/borrower absent a waiver by the underlying obligor and prior to the default of the transferor/borrower.

To sum up the critical difference between a true participation and a non-recourse secured loan: In a true participation, the transferor no longer owns the share of the proceeds sold to the participant and has no equitable right to redeem that asset, whereas in a non-recourse secured loan, the transferor continues to own the pledged asset, has the right to the excess of the asset over the obligations secured, and has an equitable right to redeem the asset.

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55 The analysis of the parties’ rights in the case of an FDIC-insured transferor is more complicated. Essentially, the participant would have a right to its share of the proceeds of the loan, although it would have to go through a claims process and ultimately judicial process if the FDIC as receiver did not pay the proceeds to it. The claims and judicial process would entail delays. The transferee/lender would, if there were a material non-insolvency-related default by the bank, be entitled to exercise its self-help remedies (including foreclosure), and would be required to pay the excess proceeds from foreclosure to the receiver. The receiver would have no right of redemption in the case of a participation, but would have a right of redemption in the case of a non-recourse secured loan.
We hope that this memorandum is helpful in assisting the Board in assessing whether a "true participation" can meet the requirements of Statement 140.

CLEARY, GOTTLIEB, STEEN & HAMILTON

SG
KAS