Syndicated Loan Considerations
Pending Litigation As a Cautionary Tale

BY JEFFREY A. WURST & JON H. RUISS, JR.

In re Oak Rock Financial, LLC, a pending bankruptcy case, addresses pitfalls associated with the structure and terms of participation agreements. Ruskin Moscou Faltischek Senior Partner Jeffrey A. Wurst and Associate Jon H. Ruiss, Jr. dissect the case, stressing the importance of clarifying interests in advance.

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Those of us who are dinosaurs in this industry recall when loan participations were more common in the middle market. The borrower's cash needs exceeded the lender's limit or the lender's desire for risk. The lender, with or without the borrower's knowledge or consent, would sell off an undivided interest in its loan to the borrower as a loan participation. Participations were very common among independent finance companies and continued in popularity as those finance companies were acquired by banks.

As a result of litigation, the business failures of some finance companies and creative "what if" thinking, participations eventually became less favored. *What if* the lender went bankrupt? Some participants perfected security interests in the lender's loan to the borrower, but that security interest would be subject to the security interest of the lender's secured creditor, if it had one. Thus, the "agented" or "syndicated" loan was introduced to the middle market. The lender now became the administrative agent and the borrower was in privity with each lender. Of course, that created the opportunity for a "co-lender" to grow a relationship with the borrower and steal away the loan for itself — that is if it was not concerned about being invited into another lending "club."

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Multi-Lender Loans: Pros & Cons

Despite the change in style, some lenders continued to sell participation interests, and some lenders continued to purchase them. Multi-lender loans can be attractive to co-lenders and participants because painstaking administrative tasks, such as servicing responsibilities, fall on the lead lender. Additionally, co-lenders and participants are able to invest in loans without the burden of the administration required to originate the loan on their own. This also allows lenders to invest in transactions too large for them to take on by themselves. Also, co-lending and loan participations allow a small lender to take advantage of a larger lender's expertise and gain access to a new market.

However, loan participations pose risks that may not have been initially apparent to a participant. While loan participations may pose an economic benefit to a lender, the lender must be aware of pitfalls associated with such an arrangement. Proper due diligence and selection of a financially secure lead are crucial factors in any decision to participate or co-lend. Typically, in a participation arrangement, the participant does not have a direct claim against the underlying borrower. Rather, the participant only has a contractual relationship with the lead lender, which can be established and circumscribed by the terms of the agreement. Thus, the participant may be at risk in the event the lead leader becomes insolvent unless the participation agreement has been properly prepared for this risk. A court will consider whether the participant purchased an undivided interest in the loan in a "true sale" or whether the participation is really a disguised loan. If it is a true sale, was the participation interest purchased subject to the security interest in favor of the lead lender's secured lender?

In re Oak Rock Financial, LLC No. 13-72251 (Bankr. E.D.N.Y April 10, 2014) is a case presently pending in the Bankruptcy Court for the Eastern District of New York that addresses some of the pitfalls associated with the structure and terms of participation agreements. In Oak Rock, the bankruptcy court analyzed the relationship that results from an agreement between a lender in the business of providing financing and parties "investing" in those loans.

Oak Rock Financial

The debtor, Oak Rock Financial (ORF), was in the business of providing financing to third parties. In order to fund its operations, ORF obtained a line of credit from a bank. The bank, in turn, acted as agent to a syndicate of several banks acting as co-lenders in the loan facility. Participants entered into participation agreements with ORF in which they provided a portion of the funds to be made available for the third-party financings.

At some point, the bank and its co-lenders alleged fraudulent conduct by ORF's principal, and subsequently filed an involuntary Chapter 11 against ORF. The participants asserted that the bank and its co-lenders did not have any claim to the participation interests purchased by the participants. The bankruptcy court was faced with the task of determining whether the participation agreements were true sales and, if so, if were they free and clear or subject to the liens granted in favor of the bank and co-lenders.

True Sale Participation

In its findings, the court applied the traditional four-part test to determine whether the parties entered into "true sale" participation agreements: whether money was advanced by a participant to a lead lender; whether the participant's right to repayment only arose when a lead lender was paid; whether only the lead lender could seek recourse against the borrower; and whether the document evidenced the true intentions of the parties. The court noted that certain participants advanced money to ORF with the understanding that only ORF had the right to seek recourse against the underlying borrower and that these participants were entitled to repayment only upon payment by the borrower to ORF. The court concluded that these parties' intentions were not only clear and unambiguous by the agreements' terms, but the conduct of the parties also reflected a lead lender-participant relationship as opposed to a lender-borrower relationship. This was good news for these participants.

Disguised Loans

The bankruptcy court next evaluated whether the agreements were "more in the nature of disguised loans." The court relied upon the following established factors: whether the lead lender had guaranteed the participant's repayment or shifted the risk from the creditworthiness of the underlying borrower to the lead lender; whether the participation lasted for a period longer than the underlying loan; whether the payment arrangements between the borrower and the lead lender, and the lead lender and the participant differed; and whether the interest rate due to the participant was higher than the interest rate paid on the underlying loan. The court found that certain participation agreements satisfied these factors.

Loan Characteristics

Other participants were not as successful. Even though the bankruptcy court found that agreements satisfied the first test, the court noted that agreements had characteristics of a loan. The court noted that in these agreements the terms differed from those of the underlying loan to the borrower. Although the agreements stated that these participants were to receive payments only if ORF received payment from the borrower, this was not sufficient to deem the agreements true-sale participation agreements.

The participants in *Oak Rock* may prevail and defeat the bank's claim but if they do, it will only be after significant litigation, cost and aggravation.

The court ultimately found that these agreements placed obligations upon ORF to return the initial investments, regardless of the status of the underlying loan, similar to a guarantee of repayment. Likewise, the bankruptcy court found in these agreements there was no sharing of risk, whereas in a true-sale participation the participant assumes the same risk as the party selling the participation. The court noted, "In sum, the lack of correlation between the terms of these participation agreements and the underlying loans militates against finding that these are true participation agreements."

An Appeal

The participants that the court deemed had not purchased true participations appealed the bankruptcy court's decision to the District Court for the Eastern District of New York. The appeal is currently pending in the district court, and the issues have been briefed by the parties. The principal argument raised by those participants is that the bankruptcy court incorrectly imputed that the participation agreements at issue included a guarantee of repayment. The agreement contained a provision stating that, in the event these participants chose to terminate the agreement at the end of their one-year term, ORF would repurchase the interest. However, the agreement also contained a provision stating that if the borrower was in default on the termination date, then ORF could opt to liquidate the participation, in which case those participants would receive their proportionate share of the proceeds. It will be interesting to see how the district court rules. > >

Challenging the Bank's Security Interest

As to those participants whose interests were deemed to be true sales by the bankruptcy court, they must still litigate the determination of whether they purchased their interests subject to the bank's security interest. The bank claims that it has a blanket security interest in all assets of ORF, and that its lien was perfected prior to the participants obtaining their interests. Thus, the bank claims that their participations were purchased subject to the bank's liens.

The participants filed an objection to the bank's security interest, challenging the validity of the bank's liens. The participants allege, in part, that the bank's financing statement lapsed in 2006. In 2006, however, the bank filed another financing statement, which covered a limited subset of ORF's assets. Subsequently, the participants purchased their interests and filed their own financing statements. In effect, the participants argue that the bank cannot bootstrap perfection to the earlier financing statement. This issue is currently being litigated in the bankruptcy court. The court will conduct a hearing to determine whether the participants purchased their interests subject to bank's security interest.

Advance Prudence

The *Oak Rock* case serves as a good reminder of the risks associated with participations. The take-away stresses the importance of properly entering into a valid true-sale participation. Participation agreements that extend past or expire prior to the termination of the underlying loan indicate that the participation agreement bears no connection to the underlying loan and is a disguised loan. A participant having recourse to the lead is another indicia of a participation not being a true-sale. In a true-sale participation agreement, the participant is repaid an amount based upon its ownership interest in the underlying loan and the amount actually repaid by the borrower. Finally, a participant must be assured that the participation interest being purchased is not subject to a security interest in favor of the lead's secured creditor. If it is, it is strongly suggested that the secured creditor clearly release its claim to the undivided interest being purchased by the participant.

The participants in *Oak Rock* may prevail and defeat the bank's claim but if they do, it will only be after significant litigation, cost and aggravation. It would have been prudent to clarify the interests in advance. We will be watching to see how the *Oak Rock* court determines the conflicting interest claim. abfj

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