The Transactional Lawyer

A Publication of the Commercial Law Center

The Perils of Participations (and Secrets to Successful Subordinations)

John F. Hilson
Stephen L. Sepinuck

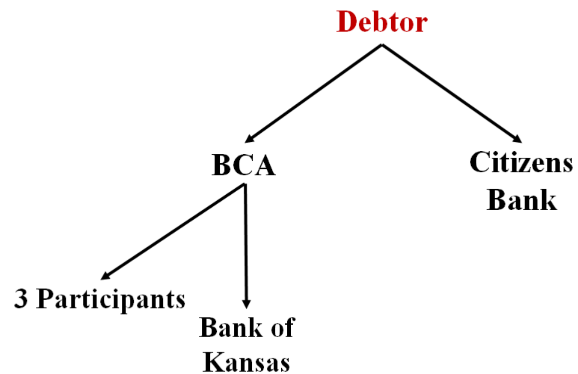
A recent bankruptcy court decision, *In re Brooke Capital Corp.*, 2012 WL 4793010 (Bankr. D. Kan. 2012), reveals some significant due diligence problems for those who acquire loan participations as well as for those who enter into subordination agreements with the lead lender. Although the decision has questionable analysis on several points and, thus, could potentially be disregarded as simply wrong or at least focused on the wrong questions, it nevertheless provides a useful focus with respect to the underlying issues.

The Facts

In 2007, Brooke Capital Corp. ("Debtor") borrowed $12.3 million from its subsidiary, Brooke Capital Advisors, Inc. ("BCA"). To secure the loan, Debtor granted BCA a security interest in stock ("Stock") that it owned of another subsidiary. BCA purported to perfect its security interest in the Stock through possession by the Debtor's attorney. The following year, Debtor granted a security interest in the Stock to Citizens Bank & Trust ("Citizens") to secure a restructured debt of approximately $9 million. In connection with that transaction, Citizens filed a financing statement to perfect its interest, BCA and Citizens entered into an escrow agreement to perfect their security interests in the Stock, and BCA agreed in writing that if either Debtor or BCA became entitled to receive, directly or indirectly, any proceeds from the sale of the Stock, it would immediately pay such proceeds to Citizens to the extent necessary to satisfy Debtor's debt to Citizens.

Prior to the transaction with Citizens, however, BCA had entered into four participation agreements with respect to its secured loan to Debtor. In three of those agreements, BCA purported to sell approximately 72¼% to three participants. Those agreements, however, also required BCA to repurchase the interests sold. In the fourth participation agreement, BCA sold approximately 14.5% of the loan to Bank of Kansas. That agreement contained no repurchase obligation. All of the participation agreements provided that BCA would not without the purchaser's consent, release or allow for the substitution of any collateral, "outside the normal course of dealing with Borrower so as to substantially reduce the possibility of repayment of the Loan."

The following diagram depicts the various transactions.



Soon after the transaction with Citizens, Debtor filed for bankruptcy protection. Eventually, the Stock was sold and the proceeds were held pending resolution of a priority dispute between the participants, BCA, and Citizens.

The Court's Analysis

With respect to the three participants (other than Citizens), the court ruled as follows: First, they did not truly buy an interest in the loan because BCA was obligated to repurchase their interests and, thus, BCA – not the participants – had the risk of loss. Instead, the transactions were properly re-characterized as loans to BCA secured by BCA's interest in its loan to Debtor.

Contents

The Perils of Participation (and Secrets to Successful Subordinations) 1
Reducing Risk in Collateral Dispositions 4
Recent Cases 5
Announcement 7

Second, while true loan participants are allowed to rely on the lead lender's perfection of security interests to protect their interests, participants who are re-characterized as lenders to the lead lender are not. Moreover, because the three participants had done nothing to otherwise perfect their interests, they had no perfected interest in the proceeds of the Stock.

The Court's analysis on this point was a bit fuzzy. If the participants in reality made a loan to the lead lender, then their collateral was the lead lender's right to repayment from the borrower – a payment intangible – not the Stock pledged by the borrower to secure that obligation. Of course, attachment of their security interest in that payment intangible would also give them an attached security interest in the lead lender's security interest in the borrower's collateral. § 9-203(g). However, *a security interest in a security interest in stock* is not the same thing as *a security interest in stock*. The court conflated the two different debtors and, thereby, confused its analysis.

In any event, given the court's conclusion about perfection, Citizens' security interest in the Stock had priority. The court further ruled that, given its priority holding, it had no need to determine whether BCA's agreement with Citizens affected these participants' rights.

As to Bank of Kansas, the court's analysis and conclusion was substantially different. That participation was held to be a true sale because there was no repurchase obligation or other recourse against BCA. Therefore, the court confronted whether BCA's subordination agreement with Citizens was binding on Bank of Kansas, which was not a party to that agreement. To answer this question, the court looked to the language of the participation agreement between BCA and Bank of Kansas. That agreement prohibited BCA from agreeing to any release or substitution of collateral outside the normal course of business of dealing with the Debtor without the consent of Bank of Kansas. The court ruled that this language applied to the subordination agreement and, because there was no evidence that the transaction was in the normal course of BCA's dealings with the Debtor, the subordination was not binding on Bank of Kansas.

Problems with the Court's Analysis

The court's analysis has numerous problems. First, with respect to the three participants who were re-characterized as lenders to BCA, their lack of perfection should have been immaterial. While their security interest in *BCA's assets* was not perfected, BCA's interest in *Debtor's stock* was. None of the authorities the court cited for the proposition that the participants could not rely on BCA's perfection really stand for that proposition. One decision, *In re AutoStyle Plastics, Inc.*, **269 F.3d 726**, 740-44 (6th Cir. 2001), ruled that true participants could rely on the lead lender's perfected status. The two cited sections of Article 9, § 9-502(a)(2) and § 9-503(d), merely provide that a financing statement must provide the name of the secured party or a representative of secured party, but that failure to indicate representative capacity does not render a financing statement ineffective to perfect. The final authority, Barkley and Barbara Clarke's treatise on Secured Transactions, similarly deals solely with the name of the secured party on a financing statement.

The court seems to have overlooked the fact that the transactions involved two different debtors. Nothing in Article 9 suggests that failure to perfect a security interest granted by one debtor affects the perfection of a security interest granted by a different debtor. Indeed, merely to phrase the issue in this manner indicates the absurdity of the court's conclusion.

With respect to the Bank of Kansas, the court's focus on the language of the participation agreement is problematic for several reasons. First, the fact that the agreement required consent to a *release or substitution of collateral* does not necessarily mean that it required consent to a *subordination of the security interest*. Indeed, those two types of transactions would likely be done through agreements with different parties: release or substitution of collateral would be effected through an agreement with the debtor; subordination would be effected through an agreement with another creditor. While it may be fair to assume that a participant who wished to restrict the former would also want to restrict the latter, the language of the agreement simply does not reach that far.

Second, and far more important, the court's approach makes the terms of the participation agreement binding on third parties. Even if the court was correct that BCA breached the participation agreement by entering into the subordination agreement, that does not necessarily mean that the subordination agreement was ineffective.

Certainly, there are some bases for that conclusion. For example, § 9-318(a) provides that a debtor who has sold a payment intangible does not retain a legal or equitable interest in it. BCA, by entering into the participation agreement with Bank of Kansas, sold a payment intangible. Therefore BCA did not retain the interest sold and, by implication – and application of the principle *nemo dat quod non habet* – could not

thereafter enter into an effective subordination agreement with respect to the interest that had been transferred. Similarly, § 9-201(a) provides that a security agreement is effective not only between the parties thereto, but also against "creditors." A participation agreement is a type of security agreement because a buyer's interest in a payment intangible is a security interest. *See* §§ 1-201(b)(35) (defining "security interest"), 9-102(a)(74) (defining "security agreement"). Therefore, the participation agreement is binding on "creditors." While no doubt this is intended to mean that it is binding on creditors of the seller/debtor – in this case, BCA – the language is not so limited and one could argue that it is also binding on creditors of the account debtor.

Neither of these arguments is particularly persuasive, however. The UCC is clear that, unless displaced by a particular provision, principles of law and equity, including specifically the law of principal and agent, supplement the Code's provisions. § 1-103(b). When a participant allows the lead lender or originator to administer the loan and remain the only secured party of record, a principal-agent relationship is created. Thus, the Court should have examined whether BCA had actual or apparent authority to enter into the subordination agreement on behalf of Bank of Kansas. Review of the participation agreement itself may be sufficient to determine whether *actual* authority existed but would not be sufficient to determine whether *apparent* authority existed.

Implications for Drafting and Due Diligence

This brings us to the practical implications of the case, of which there are several. First, participants should consider filing a financing statement. Certainly a true participant – that is, a true buyer of a payment intangible – is automatically perfected. § 9-309(3). However, a participant with a right of recourse against the lead lender may be, indeed very likely will be, deemed to have made a secured loan to that lender, in which case perfection would require filing. There will often be significant resistance to and probably little need for such a filing when the lead lender is a major financial institution. However, when, as in this case, the lead lender is an affiliate of the borrower, such a filing may be the prudent thing to do. Moreover, such a filing will guard against the possibility that some court will think it is needed to remain perfected in the account debtor's collateral. We think that aspect of the court's decision in *Brooke Capital* is simply wrong, but who is to say what other courts will be misled by it.

Second, the participation agreement should clearly indicate what the lead lender may and, more important, may not do with respect to the participation interest without the participant's consent. For example, it should expressly prohibit the lead lender not merely from substituting or releasing collateral but also from subordinating the lien. The Bank of Kansas caught a break in this respect when the court generously interpreted its participation agreement, but participants should not rely on such judicial grace.

Third, the court's decision creates significant due diligence challenges. Of course, the automatic perfection rule already does that for true participants. Because the interest of a true buyer of a payment intangible is automatically perfected, anyone considering the purchase of a participation interest cannot readily determine if the lead lender still owns the right to payment. Normally, the purchaser deals with this through representations and warranties, but representations and warranties protect the purchaser only when the lead lender is a creditworthy entity that can be relied upon to stand behind those representations and warranties. When the lead lender is an affiliate of the borrower, such representations and warranties may not be worth the ink used to print them.

The court's decision expands this due diligence problem to almost everyone who enters into a subordination agreement. It suggests that a subordination agreement will not be binding on anyone who has previously bought a participation interest in the loan that is to be subordinated, even though there may be no ready way for the counterparty to the subordination agreement to determine whether there are participants and, if so, who they are.

One might be tempted to argue that a contrary decision would not have avoided this problem but merely shifted it to the other party. In other words, if the subordination agreement were binding on a prior participant despite contractual provisions prohibiting the subordination, there would be little the participant could do to protect itself. However, that may not be true. There may be ways in which a true participant could take away the lead lender's apparent authority to act on the participant's behalf. For example, a participant might insist that the lead lender file an amendment to its financing statement. That amendment could state that: (i) the lead lender has sold a participation interest in the secured obligation; and (ii) the lead lender no longer has authority to release collateral or enter into a subordination agreement with respect to the participation interest. Given the uncertainty about whether other courts will

follow the decision in *Brooke Capital,* participants and their counsel should strongly consider taking this approach. In any event, the morals are to beware, to understand the risks, and, most important, to explain them to the client.

John F. Hilson *is a partner at Paul Hastings LLP and chair of its Finance and Restructuring Group.*

Stephen L. Sepinuck *is a professor at Gonzaga University School of Law and director of the Commercial Law Center.*

Reducing Risk in Collateral Dispositions

Stephen L. Sepinuck

The Hammer Falls

The auctioneer's gavel bangs on the podium or the second signature is placed on the sales contract. Is the disposition of collateral completed if the buyer has not yet paid or the secured party has not yet delivered the collateral? What if, moments afterwards, the debtor files for bankruptcy protection and demands return of the collateral, claiming it is now property of the estate and covered by the automatic stay? These are questions raised but not adequately dealt with in *In re Burrell*, 2012 WL 3727130 (S.D. Tex. 2012). Transactional attorneys representing secured parties should take note of the case and carefully draft agreements disposing of collateral to eliminate the risk that their clients will be confronted with competing demands for the collateral – one from the debtor and one from the buyer – and liability to whoever's claim it fails to honor.

Bad Facts Make . . .

The case began in a fairly familiar way. The secured party repossessed the debtor's BMW in July, 2010. The following month, the debtor filed a Chapter 13 bankruptcy petition. Two days later, the debtor's counsel demanded return on the BMW but the secured party at first failed to respond and later refused. The debtor then brought a turnover motion and sought damages for violation of the automatic stay.

The secured party defended by claiming that it had sold the car to another dealer the day before the petition was filed. As a result, the car was not property of the estate and no violation of the stay could have occurred. The dealer acknowledged that it had not transferred record title before the petition was filed, but claimed that the sale had nevertheless occurred.

The bankruptcy court did not believe that a sale occurred prepetition. Instead, the court concluded that the secured party had backdated the bill of sale to avoid liability for violation of the stay. It awarded the debtor actual and punitive damages in excess of $68,000.

On appeal, the district court did not base its decision on the alleged backdating of the bill of sale. Instead, it assumed that the bill of sale had in fact been signed prepetition but nevertheless concluded that the debtor still had rights in the car. Specifically, the court ruled that "[a] debtor's rights in the collateral only transfer to a third-party purchaser when a sale of the collateral is *completed*." *Id.* at *11 (emphasis added). Looking to U.C.C. § 2-401, under which title generally passes upon delivery, the court concluded that transfer of possession was necessary to transfer title and, therefore, the bill of sale did not extinguish the debtor's rights in the car. Although the secured party argued that it had in fact delivered the car to the buyer prepetition, the buyer testified that it took delivery several weeks later.

Problems with the Analysis

The trouble with the district court's ruling is that it potentially puts secured parties in a real bind. If, prepetition, they have exercised their rights under § 9-610 and contracted to sell the collateral to a third person, but not yet delivered the property or otherwise completed the transaction, then they face potential competing claims. They may have liability to the buyer under the sales contract but remain obligated to return the collateral to the debtor if the debtor attempts to redeem it or files for bankruptcy protection and demands possession.

Arguably, a better interpretation of § 9-617 is that the debtor's rights are terminated when the secured party enters into the disposition contract. In short, the debtor's rights are terminated when the hammer falls, not when the goods are delivered later. Yet even this interpretation has its problems. If, for example, the buyer defaults and refuses to consummate the sale, the debtor surely would still have a right to redeem the collateral under § 9-623. Thus, the sales contract itself cannot truly terminate the debtor's rights. One could say that by entering the contract to dispose of the collateral the debtor's rights have been conditionally terminated and are revived only if the sale falls

through. This might resolve the secured party's problem of simultaneously having liability to the buyer to honor the sales contract and liability to the debtor to honor a demand to redeem. However, since even the debtor's contingent rights become part of the bankruptcy estate upon the filing of a bankruptcy petition, the filing of a bankruptcy petition would seem to make the automatic stay applicable, and thus present the secured party with the unenviable dilemma of either honoring the sales agreement and violating the stay or complying with the stay and breaching the sales agreement.

Contractual Solution

Fortunately, there is a fairly simple solution to this potential dilemma. When contracting to dispose of collateral, the secured party should include language making the transaction contingent on there being no legal impediment to the sale arising from the debtor's redemption rights or bankruptcy. Frankly, language to that effect should be in the agreement not merely to guard against a subsequent bankruptcy filing, but also one that has already been filed. If the debtor filed for bankruptcy even an instant before the secured party reached an agreement to sell the collateral, the stay would be in effect and consummation of the sale would violate the stay even though the secured party had no reason to know that the stay had come into effect. So, the terms of sale should already be conditioned on the absence of a stay.

Condition to Seller's Duties

Seller will have no obligation or liability to Buyer under this agreement if, prior to delivery of the Goods to Buyer:

(i) Owner becomes a debtor in a case pending under Title 11 of the United States Code; or

(ii) Owner exercises Owner's right to redeem the Goods.

Stephen L. Sepinuck is a professor at Gonzaga University School of Law and director of the Commercial Law Center.

Recent Cases

SECURED TRANSACTIONS

– Attachment Issues

Shales v. Pipe-Liners, Ltd.,
2012 WL 4793499 (N.D. Ill. 2012)
Lender whose agreement with the debtor provided that it shall have the rights of a secured party "[i]f an Event of Default occurs," did not in fact have a security interest until default occurred. Even if default did not occur until judgment lien was entered against the debtor, lender did not do enough to preserve its rights because it waited eleven weeks before asserting its rights to receivables, and thus judgment lienor was entitled to the receivables.

In re Tracy Broadcasting Corp.,
2012 WL 4874485 (10th Cir. 2012)
Although federal law prohibits a security interest from attaching to an FCC license itself, a security interest can attach to the right to receive proceeds of a future sale of the license. This right attaches upon acquisition of the license; because that occurred prepetition, § 552 of the Bankruptcy Code does not apply even if, on the petition date there was no agreement to sell the license.

In re McKenzie,
2012 WL 4742708 (E.D. Tenn. 2012)
Creditor did not have a security interest in the debtor's LLC interest because the LLC operating agreement expressly provided that no member could transfer such an interest without the prior written consent of the board and that any attempted transfer without consent was void, and the creditor's evidence of *subsequent* consent did not prove that the requisite *prior* consent was given.

– Enforcement Issues

WestLB AG v. BAC Florida Bank,
2012 WL 4473445 (S.D.N.Y. 2012)
Lender with a security interest in mortgage loans did not state a claim for breach of contract against borrower or loan servicer in connection with their renting, rather than selling, foreclosed real estate. The servicing agreement, which gave the borrower authority to direct how dispositions were conducted, subject to the lender's consent, spoke only to sales of the foreclosed properties and thus did not require the lender's consent in connection with leases of the properties.

– Priority Issues

In re Brooke Capital Corp.,
2012 WL 4793010 (Bankr. D. Kan. 2012)
Agreement between two secured parties by which the senior lienor agreed to pay the proceeds of the collateralized stock to the junior lienor was an enforceable subordination agreement even though the economic assumptions underlying the agreement proved not to be correct because those assumptions were not made conditions to the subordination. Whether the subordination was binding on the three entities that acquired participations in the senior lienor's loan was moot because those interests were really loans to the senior lienor – given that the senior retained the risk of loss – and therefore those entities could not rely on the senior lienor's perfection. Because those entities had taken no action to perfect their interests, their interests were subordinate to the junior lienor's rights. In contrast, the fourth participant was a true buyer of a portion of the senior lienor's loan and thus its interest was perfected. Moreover, the subordination agreement was not binding on the fourth participant even though the senior lienor remained the servicer of the entire loan because the participation agreement required the participant's consent to any substitution of collateral outside the normal course of dealing with the borrower.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Edelman Arts, Inc. v. Art International (UK) Ltd.,
841 F. Supp. 2d 810 (S.D.N.Y. 2012)
Placement of signed purchase order in escrow was a mechanism to create a condition precedent to validity of the parties' contract, not merely a condition to the buyer's duty to pay.

Huntington National Bank v. RDJ Land & Property Group, LLC,
2012 WL 4357443 (S.D. Ind. 2012)
Intercreditor agreement that provided for lien subordination but contained no provision for debt subordination had no applicability once the collateral was foreclosed upon and the creditors were pursuing the guarantors for the deficiency.

Prudential Ins. Co. of America v. WestLB AG,
2012 WL 4854713 (N.Y. Sup. Ct. 2012)
Because credit agreement and related documents required that payments received be distributed on a pro rata basis among all the lenders and required the consent of all lenders – not merely the Required Lenders – to an amendment to the credit agreement or to the release of substantially all the collateral, the administrative agent for the credit facility was not permitted to distribute the proceeds of the collateral in a manner that substantially benefitted those lenders that provided exit financing.

In re Makris,
2012 WL 1864323 (3d Cir. 2012)
Clause in promissory note making borrower liable for lender's attorney's fees incurred "in enforcing this Note" was not broad enough to cover attorney's fees incurred in unsuccessfully pursuing the borrower for fees the lender incurred in suing the guarantor.

Citizens Bank v. Merrill, Lynch, Pierce, Fenner and Smith, Inc., 2012 WL 5828623 (E.D. Mich. 2012)
Because no contrary intention was manifest in the choice-of-law clause in the parties' control agreement, Michigan procedural law, including its six-year statute of limitations, not the chosen law of New York, with its three-year limitations period, applied to tort and contract claims brought under New York law.

Edited By:

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Director, Commercial Law Center

Scott J. Burnham
Frederick N. & Barbara T. Curley Professor
Gonzaga University School of Law

For questions or to submit content to *The Transactional Lawyer*, please contact Vicky Daniels at vdaniels@lawschool.gonzaga.edu

A Call for Participants
To Provide Workshops to Rwandan Lawyers

The Legal Capacity Building Program seeks experienced attorneys for an international pro bono project in Rwanda. The Rwanda Ministry of Justice has teamed with Eos Visions, an organization experienced in facilitating educational and training programs in Rwanda, to coordinate this pilot project. The goal is to have experienced lawyers provide workshops to significantly enhance the opportunity for Rwandan lawyers to provide legal advice in such areas as joint venture, project financing agreements, public-private partnerships, agreements related to energy and natural resource allocations, and the like. ***The tentative dates for the project are May 26-June 1, 2013***.

Background

Rwanda is a small, densely populated and landlocked country in East Africa with a complicated and tragic history. In 1994, decades of tension between the country's two main groups, Hutu and Tutsi, culminated in a 100-day genocide and war that claimed the lives of over 900,000 Rwandans. In the past 18 years, the country has made significant progress in its recovery and in promoting peaceful social and economic development. Rwanda's impressive recovery and rebuilding of its institutions is largely due to the government's emphasis on national unity, anti-corruption efforts, and effective use of foreign aid to build local capacity.

Despite this progress, Rwanda's legal professionals are largely overwhelmed with the country's on-going changes so that the main challenge today is a widespread lack of human capacity. This is particularly obvious with regard to the consistent and prompt application of the new laws. Today, with just over 600 lawyers, most of whom are relatively young and inexperienced, the country has an advocate-to-population ratio of 1 to over 16,000 citizens (compared to ratios of 1 to 265 in the U.S. or 1 to 401 in the UK). Capacity and skills building for both official and private institutions are key needs, especially when it comes to developing and implementing new elements of the common law system.

Curriculum of Training Topics

Transactional Contracts and Negotiations

Public-Private Partnerships
Privatization Agreements
Commercial Agreements
Joint Ventures
Energy/Natural Resource Exploitation
- Minerals
- Forests
- Petroleum
- Methane gas

Construction Contracts
Civil Works - Procurement
Share Purchase & Sale Agreements
Power Purchase Agreements
Financing Agreements for Project Development
Risk Allocation//Hedging Strategies for Project Development

Civil Litigation

Complaint & Answer Procedures
Service of Process & Notice
Pleadings & Discovery
Jurisdiction

Drafting

Legislation
Contracts

Alternative Dispute Resolution

Mediation of Civil Disputes
Mediation for Land/Quiet Titles
Stages of Mediation
Mediation Ethics
Training Arbitrators

For additional information, contact Professor Cheryl Beckett, Gonzaga University School of Law, at **cbeckett@lawschool.gonzaga.edu** or (509) 313-3721.

To view a presentation from Professor Beckett's time in Rwanda in December 2011 as a Rule of Law delegate, go to **http://www.law.gonzaga.edu/Faculty/faculty_watch/Beckett_Rwanda.asp**