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Editorial Offices
630 Central Ave., New Providence, NJ 07974 (908) 464-6800
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
www.lexisnexis.com

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Oak Rock Financial District Court Addresses the Applicable Legal Standard for True Participation Agreements

Jason W. Harbour and Shannon E. Daily*

The authors of this article discuss a recent United States District Court for the Eastern District of New York decision that applied the True Participation Test and the Disguised Loan Test as the applicable legal standard to determine whether an agreement constitutes a true participation agreement or a disguised loan.

The United States District Court for the Eastern District of New York recently applied two tests, the True Participation Test and the Disguised Loan Test, to determine whether agreements were true participation agreements or disguised loans.[1] In addition, the district court noted that the most important question in such a determination is the risk of loss allocation in the transaction, and that if an alleged participant is not subject to the risk of loss due to a default by the underlying borrower, then the transaction is likely a disguised loan. The United States Bankruptcy Court for the Eastern District of New York had entered summary judgment in the appealed adversary proceedings, concluding that the agreements were disguised loans and that as a result the participation interests were property of the debtor's bankruptcy estate. The district court reversed, and held that (i) one adversary proceeding involved a true participation agreement, and that as a result the participation interests were property of the alleged participant, not property the debtor's bankruptcy estate, and (ii) the agreements at issue in the other adversary proceedings contained too many ambiguities for the bankruptcy court to render summary judgment. Notably, the district court also concluded that the lack of a "true-up" provision in an alleged participation agreement for a revolving loan does not preclude the agreement from being a true participation agreement.

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* Jason W. Harbour is a partner at Hunton & Williams LLP, focusing his practice on bankruptcy and creditor's rights, loan workouts, reorganizations and corporate recovery, and on insolvency-related structuring advice and legal opinions for complex transactions. Shannon E. Daily is an associate in the firm's Bankruptcy, Restructuring and Creditors' Rights Practice Group. The authors may be contacted at jharbour@hunton.com and sdaily@hunton.com, respectively.

[1] *See Appellants v. Appellees (In re Oak Rock Financial, LLC)*, Nos. 14-03700, 14-03713, 14-03714, 14-03873, 14-03874, 14-03876, 14-03878, 14-03879, 14-04450, 2015 U.S. Dist. LEXIS 44032, at *1 (E.D.N.Y. 2015); *see also In re Coronet Capital Co.*, 142 B.R. 78 (Bankr. S.D.N.Y. 1992).

CASE BACKGROUND

Oak Rock Financial, LLC ("Oak Rock") operated a specialty asset-based lending business, which provided financing to third parties pursuant to financing installment contracts for the purchase of goods. Oak Rock borrowed funds from commercial banks and private investors and then loaned such funds to certain dealers, who in turn used the funds to finance installment contracts.

On April 29, 2013 (the "Petition Date"), the agent under Oak Rock's revolving credit facility (the "Agent"), along with two other banks, filed a petition for involuntary relief under Chapter 7 of the United States Bankruptcy Code (the "Bankruptcy Code") against Oak Rock. On May 6, 2013, the bankruptcy court converted the case to Chapter 11.

Oak Rock subsequently commenced a number of adversary proceedings[2] against certain parties (collectively, the "Alleged Participants") to alleged participation agreements (collectively, the "Alleged Participation Agreements") and the Agent. In the adversary proceedings, Oak Rock and the Agent argued that the Alleged Participation Agreements were not true participation agreements, but instead were disguised loans, and that as a result the participation interests at issue were property of Oak Rock's bankruptcy estate. Oak Rock and the Agent also argued that if the Alleged Participants held any legal interest in the loan proceeds related to the respective participation interests, their interests were subject to the first priority perfected lien held by the Agent in all of Oak Rock's property. The Alleged Participants disputed these arguments, asserting that the Alleged Participation Agreements were true participation agreements and that as a result, the participation interests were property of the Alleged Participants, not Oak Rock's bankruptcy estate.

In addition, the Agent argued that even if the Alleged Participant Agreements were true participation agreements, the proceeds of the participation interests sold to the Alleged Participants did not meet the requirements of Bankruptcy Code § 541(d), which exempts certain property from a debtor's estate.[3] The

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[2] The adversary proceedings on appeal are as follows: District Court Case No. 14-03700/Bankruptcy Court Case No. 13-08079; District Court Case No. 14-03713/Bankruptcy Court Case No. 13-08102; District Court Case No. 14-03714/Bankruptcy Court Case No. 13-08154; District Court Case No. 14-03873/Bankruptcy Court Case No. 13-08103; District Court Case No. 14-03874/Bankruptcy Court Case No. 13-08077; District Court Case No. 14-03876/Bankruptcy Court Case No. 13-08078; District Court Case No. 14-03878/Bankruptcy Court Case No. 13-08157; District Court Case No. 14-03879/Bankruptcy Court Case No. 13-08119; and District Court Case No. 14-04450/Bankruptcy Court Case No. 13-08078.

[3] Supplemental Findings of Fact and Conclusions of Law [AP D.I. 102] at 6, *In re Oak Rock*

Agent argued, among other things, that § 541(d) covers only purchasers of interests in the secondary mortgage market, not purchasers of interests in revolving commercial loans. The bankruptcy court disagreed with the Agent and concluded that § 541(d) applies to commercial loan participation agreements.[4]

The bankruptcy court granted summary judgment to the Agent concerning the adversary proceedings on appeal, and held that the Alleged Participation Agreements were not true participation agreements and that each Alleged Participant was an unsecured creditor of Oak Rock.[5] Certain of the Alleged Participants appealed the bankruptcy court's decision.

THE DISTRICT COURT DECISION

With respect to the appeals other than the appeal involving ZFI Endowment Partners, L.P. ("ZFI"), the district court reversed the entry of summary judgment in favor of the Agent and held that ambiguities in the Alleged Participation Agreements precluded granting summary judgment to the Agent.[6] In the ZFI appeal, the district court reversed the bankruptcy court's decision and concluded that the ZFI Alleged Participation Agreement constituted a true participation agreement.

The district court indicated that the legal standard for determining whether an agreement constitutes a true participation agreement or a disguised loan involves two tests, the True Participation Test and the Disguised Loan Test.

Under the True Participation Test, the following factors indicate that an agreement is a true participation agreement: "1) money is advanced by participant to a lead lender; 2) a participant's right to repayment only arises when a lead lender is paid; 3) only the lead lender can seek legal recourse against the borrower; and 4) the document is evidence of the parties true intentions."[7]

The Disguised Loan Test provides that the following factors indicate that an agreement is a disguised loan as opposed to a true participation: "1) guarantee of repayment by the lead lender to a participant; 2) participation that lasts for

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Financial, LLC), No. 13-80777 (Bankr. E.D.N.Y. Apr. 10, 2014) (the "Supplemental Findings").

[4] *Id.* at 18. This issue was not raised before the district court on appeal, and therefore, not discussed within the district court's opinion.

[5] Transcript of Summary Judgment Hearing [D.I. 547] at 60, 14:21, *In re Oak Rock Financial, LLC*, No. 8-13-72251 (Bankr. E.D.N.Y. Apr. 2, 2014) ("Transcript").

[6] *Oak Rock*, 2015 U.S. Dist. LEXIS 44032, at *62.

[7] *Id.* at *27 (quoting *Coronet Capital Co.*, 142 B.R. at 82).

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."[8]

The district court noted that "[t]he most determinative factor of all of these is the risk allocation involved in the transaction. If the participant does not bear the same risk of loss as the seller, or if the seller has made a guarantee of payment to the participant, the transaction is generally considered a loan and not a sale."[9] Similarly, the district court stated that "the most important question is whether the alleged participant is subject to the risk of loss resulting from default by the underlying borrower. If the participant is not subject to that risk, the transaction is a loan to the participant seller, not a participation in the seller's loan to its borrower."[10]

Under the True Participation Test, the district court focused on the second, third, and fourth factors concerning the non-ZFI Alleged Participation Agreements. The district concluded that factor two could not be satisfied because the Alleged Participation Agreements were ambiguous as to whether the right to repayment arose only when Oak Rock was paid, thereby precluding a granting of summary judgment.[11] The district court noted some ambiguity with respect to factor three, but reasoned that language providing Oak Rock with "sole authority for and on behalf of the parties" to administer the Alleged Participation Agreements, though not explicit, weighed in favor of finding a true participation.[12] Finally, the district court concluded that the fourth factor weighed in favor of finding a true participation because the parties entitled each agreement a "Participation Agreement" and referred to each agreement as such.[13]

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[8] *Id.*

[9] *Id.* at 27–28 (quoting *In re Corporate Financing, Inc.*, 221 B.R. 671 (Bankr. E.D.N.Y. 1998).

[10] *Id.* at 28 (quoting *In re Brooke Capital Corp.*, No. 08-22789-7, 2012 Bankr. LEXIS 4797, at 15 (Bankr. D. Kan. Oct. 5, 2012), *rev'd sub nom. S. Fid Managing Agency, LLC v. Citizens Bank & Trust Co.*, No. 12-2702-JTM, 2014 U.S. Dist LEXIS 4344 (D. Kan. Jan. 14 2014), *rev'd sub nom. In re Brooke Capital Corp.*, 588 F. App'x 834 (10th Cir. 2014).

[11] "Paragraph 1 suggests that the Alleged Participants would be paid a set interest rate on a particular schedule, however Paragraph 6's language that all compensation would only be paid 'as and when actually received' could be rendered superfluous if the Paragraph 1's interest payment schedule was not conditioned on Oak Rock's receipt of payments from the Dealers 'as and when actually received.' " *Id.*

[12] *Id.* at 32.

[13] *Id.* at 33.

The district court then applied the Disguised Loan Test to the non-ZFI Alleged Participation Agreements. Concerning the first factor of the Disguised Loan Test, the district court stated that the Alleged Participation Agreements were ambiguous as to whether Oak Rock guaranteed repayment to the Alleged Participants[14] The district court noted that the second factor weighed in favor of the Alleged Participation Agreements being disguised loans because the participations were for different periods of time than the underlying dealer loans.[15] With respect to the third factor, which the bankruptcy court found to be significant, the district court stated that not containing "true-up" provisions, which would have required the advancement of additional funds by the Alleged Participants if and when additional funds were advanced on the underlying loans, "is not determinative, as different payment arrangements is just one factor to be considered."[16] The district court also noted that other aspects of the payment arrangements were similar. Finally, the district court stated concerning the fourth factor that "[i]f there is a lower interest rate on an Alleged Participation Agreement than the corresponding Dealer Loan, this would weigh in favor of finding a true participation agreement, however if the interest rate is higher, this would weigh in favor of finding a 'disguised loan.' "[17]

In light of the ambiguities concerning factors in the True Participation Test and the Disguised Loan Test, and in particular the ambiguities concerning whether the non-ZFI Alleged Participation Agreements provided for guaranteed payments to the Alleged Participants, the district court concluded that the bankruptcy court improperly granted the Agent summary judgment.

With respect to ZFI, the district court first addressed whether it had jurisdiction to hear the appeal. The Agent argued that the district court lacked jurisdiction because the underlying *ZFI* adversary proceeding was ongoing, thus rendering ZFI's appeal interlocutory.[18] The district court agreed that ZFI involved an interlocutory appeal, but found that the applicable factors weighed

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[14] Paragraph 1 "sets out a specific payment schedule of interest payments, [but] there is no explicit guarantee that Oak Rock will pay this amount to the Alleged Participants if it does not receive payments from the Borrowers on the underlying Dealer Loans. If Oak Rock's obligation under Paragraph 1 is conditioned on its receipt of payment from the Dealers provided in Paragraph 6, then it cannot be said that Oak Rock has guaranteed repayment in the event of default by the Dealers." *Id.* at 39.

[15] *Id.* at 40.

[16] *Id.* at 44.

[17] *Id.* at 47 (citing *In re Brooke Capital Corp.*, 2011 Bankr. LEXIS 210).

[18] *Id.* at 49–50.

in favor of granting ZFI's request to appeal the bankruptcy court's summary judgment order.[19]

Considering the merits of the ZFI appeal, the district court reversed the bankruptcy court's entry of summary judgment in favor of the Agent and instead granted summary in favor of ZFI. Although the bankruptcy court had concluded that the ZFI Alleged Participation Agreement satisfied the True Participation Test, the bankruptcy court concluded that the ZFI Alleged Participation Agreement was a disguised loan based on the Disguised Loan Test.[20] The district court disagreed, concluding that the Disguised Loan Test indicated that the ZFI Alleged Participation Agreement was a true participation agreement.[21] The district court noted that the bankruptcy court focused on a provision of ZFI's Alleged Participation Agreement that allowed ZFI to terminate at the end of its one-year term and obligated Oak Rock to repurchase ZFI's interest, but ignored a separate provision that authorized Oak Rock to liquidate the participation upon the occurrence of a default and pay ZFI only its proportionate share of the liquidation proceeds.[22] The district court concluded that this second provision demonstrated that ZFI and Oak Rock proportionally shared the risk of borrower default, thus weighing against finding a disguised loan.[23] The district court also noted that the bankruptcy court failed to address that the ZFI Alleged Participation Agreement and the underlying loan documents shared the same interest rate, a fact also weighing against finding a disguised loan.[24] Finally, with respect to factor three of the Disguised Loan Test, the district court found that the lack of a "true-up" provision in the Alleged Participation Agreement did not preclude a finding of a true participation because "a participation is, by its nature, contractual, [and] the parties to a participation agreement may choose whatever terms they wish and the agreement will generally be enforced as to its terms."[25] As a result, the district court concluded that the ZFI Alleged Participation Agreement was a

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[19] The district court considered the following factors: "(1) whether such order involves a controlling question of law, (2) as to which there is substantial ground for difference of opinion, and (3) an immediate appeal from the order may materially advance the ultimate termination of the litigation." *Id.* at 53 (internal citations omitted).

[20] *Id.* at 57.

[21] *Id.*

[22] *Id.*

[23] *Id.* at 58.

[24] *Id.* at 59–50.

[25] *Id.* at 60–61 (internal citations omitted).

true participation agreement.[26]

CONCLUSION

The district court's decision in *Oak Rock* applies the True Participation Test and the Disguised Loan Test as the applicable legal standard to determine whether an agreement constitutes a true participation agreement or a disguised loan. The district court's decision indicates that applying these tests requires a fact-intensive inquiry that involves applying the relevant factors to all of the provisions of the agreements at issue. In addition, the district court's decision supports the proposition that the lack of a "true-up" provision in a participation agreement concerning underlying revolving loans, in and of itself, will not preclude the agreement from being a true participation agreement.

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[26] *Id.* at 61.