as domestic accounts. Between 10:53 a.m. and 2:02 p.m., the bank processed another 46 wire transfers. Altogether the bank transferred $1.9 million out of the customer's account.[77] In two previous years, the customer had made only two wire transfers, both in 2007.[78] In these circumstances, the customer contended that the bank's failure to question the wire transfers constituted a lack of good faith.[79] The court agreed, finding a genuine issue of fact existed whether the bank acted in good faith in view of prior wire activity, the number of sudden wire transfers, and the destinations of the payments.[80] At a bench trial, the court ruled in favor of the customer. The bank presented evidence only on the subjective element of good faith, failing to "present evidence from which this Court could determine what the 'reasonable commercial standards of fair dealing' are for a bank responding to a phishing incident such as the one at issue and thus whether" the bank satisfied "the objective prong of the 'good faith' requirement."[81] As a result, the court as "trier of fact [was] inclined to find that a bank dealing fairly with its customer, under these circumstances, would have detected and/or stopped the fraudulent wire activity earlier."[82]

B. Liability When the Customer is Not the Source of the Security Leak

An important exception exists to Article 4A's allocation of liability to the customer. Under section 4A-203(a)(2) a customer will not be obligated to bear the loss where it can prove the payment order was not issued by (a) it or its agent or (b) someone who gained knowledge of the security procedure (*e.g.*, user ID, password, etc.) from it or its agent.[83] This provision specifically eliminates negligence of the customer; the issue is whether the customer was the source, "regardless of how the information was obtained or whether the customer was at fault."[84] The exception functions like an affirmative defense in litigation, for which the customer bears the burden of proof under section 4A-203(a)(2).[85] As the Comments note, while the "burden of making available commercially reasonable security procedures is imposed on receiving banks," the corresponding "burden on the customer is to supervise its employees to assure compliance with the security procedure and to safeguard confidential security information and access to transmitting facilities so that the security procedure cannot be breached."[86] The purpose behind this exception is pragmatic, and based on the reality that criminals have two avenues of attack, against either the bank or the customer.[87]

Conclusion

In assessing whether a bank or its customer should bear the loss for a fraudulent EFT, the key determination is whether the bank's security procedures were commercially reasonable under the UCC and newly developing case law. In this regard, the parties should focus on: (i) the terms of any bank-customer agreements; (ii) whether the bank's security procedures complied with banking agency guidelines; (iii) whether the bank's security procedures were designed to meet the circumstances of the customer, as opposed to a one-size-fits-all approach; and (iv) whether the bank implemented and followed readily available security procedures in connection with the transactions at issue.

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LOAN PARTICIPATIONS – TIME FOR ANOTHER LOOK
Part II
By Andrew Connor

This is the second part of an article about loan participations -- arrangements between lenders in which one makes a loan to a borrower and, then or later, sells an interest in the loan to another lender. In the first part, we looked at the duties of the lead to the participant. In this article, we look at how courts have viewed participations: what sort of claim does the participating lender hold, and against whom?

Our investigation was prompted by a client that held a participation in a loan and was unhappy to learn that the lead was proposing to sell the loan to a third party, apparently without notifying the third party of the existence of the participation. What rights did our client have? Very few, we found, upon review of the participation agreement. It was a one-sided document which gave the lead broad powers to administer the loan as it saw fit, as well as to sell it.

We reviewed the law to see what duties the lead lender owed to the participant and were dismayed by what we found (See part 1 of this article). Having concluded that the caselaw, taken with the wording of our client's participation agreement, failed to impose meaningful duties on the lead with respect to the participant, we turned to considering the nature of the participation interest itself. The participation agreement said that our client owned an *undivided interest* in the loan. That, we thought, should give it status as a creditor of the borrower with recourse to the borrower to enforce the debt, even if the lead failed to seek collection or sold its interest in the loan. But what we found in the cases did not confirm that.

What sort of interest is a participation? Well, there are a few cases which have suggested that a participation might be a joint venture. In *Great American Mortgage Investors v. Louisville Title Insurance Company,*[88] the court said a loan participation was as a "joint adventure" because there were (1) a community of interest between the two lenders, (2) joint rights of control, and (3) sharing of profits and losses and costs and expenses. But, since the lender-borrower relationship remains with the lead lender and most participation agreements give the participant very little control, the element of control was probably missing. The court avoided deciding the point by ruling that, in the alternative, the arrangement was an assignment without recourse and an agency, where the lead lender acted as agent for the other. As a result, the participant, Great American, had imputed to it knowledge which the lead lender had of title restrictions on the property securing the loan and therefore could not have justifiably relied on the title insurer's misrepresentation that no restrictions on title existed.

Royal Bank of Canada v. Interfirst Bank Fort Worth, N.A.[89] concluded that no joint venture existed between the lead and the participant because the participant, Royal Bank of Canada, did not have a joint right of control over the loan. Instead, the court characterized the transaction as one in which the participant was an assignee and the lead was the agent for servicing the loan. Among other things, Royal Bank complained that the lead had breached the participation agreement because, as an assignee, Royal Bank was entitled to all the protections of the loan documents and the lead had waived certain defaults by the borrower without Royal Bank's consent. The court, however, held that the participant could not claim the benefits and protections of the original contract between the lead bank and the borrower.

Thus, even though an assignment is normally viewed as transferring ownership rights in the assigned property, the courts have not viewed a participation as direct ownership of part of the loan. Cases going back to at least 1965 have held that the interest acquired by the participant is something less than direct ownership. Two decisions handed down more than 40 years ago established what now seems the accepted view that the participant has no ownership interest in the actual loan. One is *In re Yale Express System, Inc.*[90] , cited by the court in *Royal Bank*. The other is *FDIC v. Mademoiselle of California*[91].

In *Yale Express*, the court ruled that the participant could not set off deposits of the borrower against the participant's interest in the loan. There, the lead, First National City Bank ("FNCB") made a loan to Yale Express and then sold a participation to Marine Midland Trust Company. According to the court, the participation agreement provided that Marine Midland took an undivided 40% participation in each advance made by FNCB to Yale Express. The participation agreement did not give Marine Midland any right to receive any payment from Yale Express, nor did it give Marine Midland any right to approve changes to the terms of the credit agreement or any underlying security agreement. Marine Midland had only a right to be paid by FNCB an agreed share of whatever FNCB received from Yale Express. Yale Express, however, maintained a deposit account at Marine Midland, which was probably a reason why Marine Midland bought the participation. When Yale Express defaulted and filed bankruptcy, Marine Midland set off some $361,739.71 in deposits it was holding against its share of the loan. Yale Express's trustee challenged the setoff for lack of mutuality and the court agreed, holding that Marine Midland was not a creditor of Yale Express and therefore held no debt to set off against the deposit.

Yale Express was followed by the U.S. Bankruptcy Court in *In re Okura & Co. (America), Inc.*[92] There, a participant sought to file a claim directly against the borrower in bankruptcy. The court held that the participation agreement did not give the participant any rights against the borrower, noting that many courts have "grappled with question similar" and held that participants may not claim directly against the borrower. *Mason Dixon Lines Inc. v. First National Bank of Boston*[93] also followed *Yale Express* and rejected an argument by a borrower in bankruptcy that the lead could not collect with respect to the portion of the loan that had been participated, the court saying that borrower's obligation is only to the lead and for the full amount of the loan.

FDIC v. Mademoiselle of California involved an insolvent lender, rather than an insolvent borrower. San Francisco National Bank ("SFNB") made a loan to Mademoiselle of California and then sold an 80% participation to Union Bank. The wording of the participation document described the interest sold as "a participation of $46,400.00 being a portion of the following described note made payable to [SFNB]". Subsequently, SFNB was declared insolvent and Mademoiselle sought to offset its deposit account balance at SFNB against the loan.[94] The district court held that Mademoiselle was entitled to set off the deposit and that Union Bank was entitled to a "preferred claim" against the assets of SFNB for 80% of the deposit setoff amount, which would have been entitled to priority in payment over the claims of general creditors.

But on appeal, the Ninth Circuit Court of Appeals reversed the latter part of the district court's ruling, holding that Union Bank did not have a preferred claim, thereby leaving Union Bank with nothing but an unsecured general creditor claim against SFNB for an amount equal to 80% of the setoff amount. The rationale advanced for this was that a direct recovery against the receiver for SFNB would only be authorized where it was established that "the property is not that of the [insolvent] bank but that of the claimant" – meaning Union Bank. So Union Bank had to "identify a specific fund or payment in the possession of the receiver cognizable in equity as Union's own property" in order to have a "preferred claim" to share in such fund.

Union Bank argued that it was an assignee of 80% of Mademoiselle's note and to that extent stood in the shoes of SFNB as a creditor of Mademoiselle, subrogated to a banker's lien claim against Mademoiselle's deposits. The court acknowledged that an assignment of payments to be made in the future passes legal title in the proceeds to the assignee, but said that here the offset was not against future payments, merely against "previously established credits" and was therefore insufficient to establish a fund against which Union Bank could claim. Union Bank would have had a preferred claim only if, and to the extent that, there was a "preferred fund"- meaning a payment by the borrower to SFNB. In the court's opinion, deposits existing at the time when SFNB was declared insolvent did not constitute such payments and were not a "preferred fund".

Mademoiselle of California contrasts with *Delatour v. Prudence Realization Corporation*[95], a 1948 case from the Second Circuit Court of Appeals which effectively treated the participants as direct owners of the underlying debt. There, investors were sold participation certificates in a single mortgage of an apartment building and the debt instrument which was secured thereby. The mortgage debt bore interest at 6% but the participation certificates provided for 5.5% interest, with the difference to be retained by Prudence, which serviced the mortgage and also guaranteed the payments of principal and interest on the participation certificates.[96] The mortgagor defaulted and subsequently Prudence defaulted on its guaranty. The property was eventually sold and the certificate holders then claimed that they should receive interest at the mortgage rate of 6%, rather than the lower certificate rate.[97] Each of the certificates provided that it assigned to the purchaser an undivided share or part of the bond and mortgage equal to the face amount of the certificate and bore interest at 5.5%, payable semi-annually.

The certificate holders claimed that they owned their portions of the mortgage as tenants in common and by virtue of such status were entitled to have the mortgage paid in accordance with its terms, including interest at the mortgage rate. The court agreed, finding that "the certificates were made payable by reference to the payments on the mortgage" and that the lower 5.5% rate was applicable only if the guarantor performed its guaranty.

> "When the grace period expired without the guarantor's having made good its guaranty, the limitation upon interest due holders became null and void as of the date the mortgage matured and the certificate holders became entitled to their share of the mortgage itself, or its proceeds, with interest thereon at the mortgage rate from that time."

This result doesn't reconcile with the idea that the participants were creditors of Prudence whose claims were secured by the underlying mortgage loan, because in that case they would only have been entitled to recover the amount owed by Prudence, as to which the applicable interest rate was 5.5%. Instead, this decision suggests that the participants were assignees of the loan and mortgage, subject to a contract under which they agreed that the lead could retain half a percentage point of the interest in return for providing the guarantee and acting as agent for servicing.

Delatour is the exception, however. Almost all courts to have considered the issue have held that participants do not have direct rights against the borrower. For example, in *In re Autostyle Plastics, Inc.*,[98] a second lien lender argued unsuccessfully that participants' claims were against the borrower (a debtor in bankruptcy) rather than against the lead lender (which held a first priority security interest in the borrower's assets). Had the participants' claims been viewed as claims against the borrower, they would have been lower in priority than the second lienholder's position. The court, however, found that the participation agreements in question were "true" participations where the participants' right to repayment only arose when the lead lender was paid and only the lead had rights against the borrower.

Mademoiselle of California can be distinguished from *Delatour* because in *Delatour* the participants were seeking recovery based on the collateral which expressly was stated to secure the participants' participations. *Mademoiselle of California* doesn't say that the deposits were collateral expressly securing the borrower's loans from SFNB or that SFNB's rights against the deposits secured the participation of Union Bank.

This point is also made in *In re Alda Commercial Corporation*[99], where the court held that the participant had no interest in the property of Alda, the bankrupt lead, including the participated loans (which evidently were still performing), even though the participation agreement stated that Alda and the participant agreed to be joint venturers with respect to the subject loans. The court decided that, notwithstanding such provision, the relationship between Alda and the participant was not a joint venture, just a purchase of an interest in the loans and "the participant was limited as to collection to monies obtained by" Alda from the borrowers. The participant apparently believed that it had a security interest in Alda's loans to the borrowers, but since it had not perfected that security interest by filing a financing statement, the court dismissed that assertion as unenforceable as to creditors of Alda.

Alda is unclear about whether the participant would have a preferred claim with respect to subsequent payments actually made to the receiver, stating only that the participant could file his claim as a general creditor of the lead, and that the participant would be limited to monies collected on the loans. Nothing was said as to whether the claim would have priority with respect to any such collections, only that the participant's claim would not be payable from Alda's other assets.

Penn Square Bank, N.A. failed notoriously on July 5, 1982 when it was declared insolvent by the Comptroller of the Currency and the FDIC was appointed receiver. In the ensuing winding up, there arose several cases involving loan participations sold by Penn Square where the "upstream" lenders sought to share in offsets of deposits or other collateral held by Penn Square. The cases present more than one theory of recovery on behalf of the participants, but the courts more or less uniformly rejected these claims and followed the rule, set forth in *Mademoiselle of California*, to the effect that a participation doesn't create rights against the borrower's deposits and there must be a fund to claim against for the participant to have a preferred claim against an insolvent lead.

Chase Manhattan Bank, N.A. v. FDIC[100] is instructive. Chase Manhattan Bank had acquired loan participations from Penn Square. When the FDIC declared Penn Square insolvent, it commenced offsets of funds on deposit against indebtedness owed by the depositors, including borrowers under the loans in which Chase participated. Chase demanded that the FDIC remit to Chase a percentage of such deposits equal to Chase's percentage share of the relevant loans. The FDIC refused. In the ensuing litigation, the FDIC informed the court that it would provide Chase with a "Receiver's Certificate"[101] for Chase's pro rata share of the amounts offset. The FDIC also said that if any payments were made to the FDIC by the borrowers on the loans, the FDIC would remit to Chase its percentage share of those amounts.

The court first noted that the borrowers were entitled to insist on offset, per *Mademoiselle of California*, which it cited as "the leading and in fact only cited authority" with respect to the issue at hand, saying *Mademoiselle of California* "extended the general rule of the depositors' right of offset to situations involving loan participations." Going on, the court said:

> "There [in *Mademoiselle*] the Court held, as a matter of law, that an offset of a deposit against a participated loan does not augment the insolvent estate and therefore does not generate funds which could become the basis for a preferred claim."

Chase, apparently mindful of the requirements laid out in *Mademoiselle*, had alleged the requisite elements – that the offset had created a fund which augmented the estate of Penn Square. But the court disagreed and said that an offset was not a payment but merely a bookkeeping transaction.

Chase also argued that *Mademoiselle* was distinguishable because the borrower did not know of the existence of the participation, whereas at least some of the borrowers of the loans in which Chase held participations knew that Chase had an interest. The court acknowledged that the *Mademoiselle* court regarded the lack of such knowledge as "an additional equity in favor of the borrower-depositor's right of setoff", but did not agree that such distinction should change the outcome.

Finally, Chase claimed that the deposit accounts were collateral to Chase – that Penn Square had granted to Chase a "direct interest" in the collateral security for the participated loans. Had it prevailed on this argument, Chase would have been on a footing with the participants who prevailed in *Delatour*. The court, however, reviewed the language of the participation certificates issued to Chase and disagreed:

> "No security interest in the collateral securing the participated loans was granted to Chase. It is also clear that Penn Square Bank did not assign, either in whole or in part, the participated loans or the collateral securing such loans to Chase. The provisions of the participation agreement state that a participation is "sold" to the participating bank. Penn Square Bank reserved the right to enforce the obligations of the borrower. Security for loans was specifically pledged to Penn Square Bank. Most importantly, Penn Square Bank retained the notes themselves which evidenced the loans and collected the payments on the notes from the borrowers.
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> * * *
>
> While an assignee has actual property rights with respect to the assigned accounts . . . the participating bank which is not an assignee has merely contractual rights and no property rights in the participated loans or the collateral securing them."

The *Chase* decision can be viewed narrowly as resting primarily on construction of the actual wording of the participation agreement. But the court ignored the fact that in *Mademoiselle of California* the party demanding offset was the borrower, whose rights clearly should not be prejudiced by the existence of a participation (particularly an unknown participation), whereas in *Chase* the party insisting on offset was the receiver of the lead bank and the lead clearly had obligations to Chase. Had there been no offsets, Penn Square's receiver would have been liable to the customer for the deposits and, up to the insured maximum, the FDIC would have made good to the depositor, who could then have paid the funds received from the FDIC (in its capacity as insurer) in cash to the FDIC (in its capacity as receiver) to be applied against the loans, obligating the receiver to share those payments with Chase. At least to that extent, one might think that the insured deposit amount of each borrower constituted an identifiable fund from a third party (the FDIC, in its capacity as insurer) that would have been available for Chase to claim against. But the court chose to ignore that the FDIC was wearing two hats in the matter, one as insurer and one as receiver.

The participant also lost on this issue in *Hibernia National Bank v. FDIC*,[102] where the court held that the participation agreement did not transfer from Penn Square to the participant Hibernia National Bank an ownership interest in the subject loans. The court made this holding even though the actual participation document expressly acknowledged Hibernia's participation and confirmed that Penn Square was holding for Hibernia's account a pro rata interest in the unpaid principal of the subject note, together with the same proportionate interest in any and all interest on the note, and in *any and all collateral securing the same*, together with any guaranties thereof.

As in *Chase*, the court held that Hibernia did not have a preferred claim to its share of the borrowers' deposits offset by the receiver against the participated loans. The court's description of the relationship between Penn Square and Hibernia was that "The lead [Penn Square] is the only secured party. The participants can look solely to the lead for satisfaction of their claims *because they are not themselves creditors of the borrowers and cannot assert claims against the borrowers*." (Italics supplied.)

The Northern Trust Company also participated in some Penn Square loans, receiving certificates of participation virtually identical to those issued to Hibernia. Predictably, when Northern Trust sued seeking its share of offset deposits, the court ruled in favor of the FDIC.[103] Specifically, the court said that the wording in the certificates did not "create or transfer any ownership or property rights in the participated loan or the supporting collateral". Straining, the court reached this conclusion while at the same time holding that the participation certificates "clearly and unambiguously" established an assignment and agency. It is difficult to see how there could be an assignment from Penn Square to Northern Trust without making Northern Trust into a creditor of the borrower under the assigned note, but Northern Trust's claim was denied.

Yet another Penn Square case reaching a similar outcome is *Seattle-First National Bank v FDIC*,[104] where the court held that Seattle-First National Bank ("Seafirst"), as participant, was not entitled to share in setoffs of deposits. In this instance, there was a Participation Agreement as well as a Certificate of Participation. By its terms, the Participation Agreement controlled, and the full text of the Participation Agreement is set out in the body of the opinion. Unlike the documents in Chase, Hibernia and Northern Trust, this document described the transaction as a sale of the participation and expressly said that Seafirst would own an undivided interest in the loans. Section 2 thereof stated:

> 2. *Owner Trustee*. To the extent of its participation in the loans, Purchaser [Seafirst] shall be the owner of an undivided fractional interest in each such loan, including, but not limited to, all notes and other instruments evidencing indebtedness of the borrower, together with all collateral securing such indebtedness. To the extent of Purchaser's interest therein, including, but not limited to, its pro rata share of all funds and payments received and/or to be received by Seller [Penn Square] from the borrowers. Seller shall be a trustee for the benefit of and accountable to Purchaser, and shall hold all such notes, mortgages, and collateral security instruments together with all such funds and payments in trust for Purchaser for its sole and exclusive benefit.

Notice that the agreement expressly said that Seafirst *owned* an interest in the loans, together with all collateral securing the loans, and Penn Square *shall be a trustee* for the benefit of Seafirst. Notwithstanding that the court found "that the agreement arguably created and conveyed property rights in the participated loans", and acknowledged that the agreement referred to Seafirst as the "owner" of a fractional interest in the loans, it nevertheless concluded that Seafirst "acquired nothing more . . . than an expectation of the borrower's repayment".

Seafirst also claimed that a trust was created and Penn Square was trustee for the benefit of Seafirst, based on the wording in Section 2 but also relying upon wording elsewhere in the agreement obligating Penn Square to immediately place all payments on the loans in a reserve account as soon as collected, and obligating Penn Square to consult with Seafirst on any matter that might affect Seafirst's interest in the loans. The court rejected that argument because other provisions of the agreement indicated that Penn Square retained sole management of the loans and collateral and was the sole secured party, and because Penn Square did not have to take enforcement action requested by Seafirst unless Seafirst first indemnified Penn Square for Seafirst's share of any expense or liability incurred in connection with the requested action. Moreover, said the court, banks engaging in commercial arm's length transactions do not stand as fiduciaries to each other.

The court finished by invoking *Mademoiselle of California*, saying that even if Seafirst were to succeed on its property and trust arguments, the FDIC would prevail if the offsets were proper because such offsets did not create a fund for Seafirst to claim against. So Seafirst's participation was subject to the right of the borrower to require offset, and therefore, according to the court, Seafirst should bear the risk of Penn Square's creditworthiness and solvency.

Arguably, the decisions in *Chase*, *Hibernia* and *Northern Trust* can be justified on the grounds that in each case the participation did not assign or sell an interest in the loan and was nothing more than a contract between the participant and Penn Square under which Penn Square promised to make payments only if it received payments from the borrower, and that the offsets weren't payments from the borrowers within the meaning of the participation agreements. (But why would any of the participants, sophisticated commercial lenders all, have agreed to that -- that Penn Square could reduce the debt without compensating the participant for its share of the reduction? It defies belief.) *Seattle-First National Bank* is harder to explain or accept. Assuming that the parties intended that Seafirst would be a co-owner of the loans, one wonders how that could have been expressed any more clearly. But notwithstanding the clarity of the language, the court concluded that the Participation Agreement was ambiguous as to the existence of both property rights and trust relations, and that it did not confer on Seafirst status as a creditor of the borrower. Instead, said the court, the "ownership interest" acquired was "merely its share of an expectation generated, managed, enforced and collected by the lead bank, Penn Square."

In short, the cases seem to say that the document between the lead and the participant didn't give the participant rights in the loan, regardless of the wording. Instead, a participation only created rights whose scope was to be determined by reference to the performance of the loan. *Shadow rights*, they might be called. Lender B gets paid only if Lender A gets paid and only based on what Lender A receives.

Our client's participation agreement said it was an assignment of an undivided interest in the lead's right, title and interest in and to the loan, loan documents and collateral, but it also gave the lead control of the loan and excluded our client from administration and collection of the loan. We reluctantly concluded that the client would be fighting an uphill battle if it tried to act directly against the borrower. Moreover, legal action by our client against the borrower might be viewed as violating the lead's right to control administration and collection efforts, giving rise to possible breach of contract claims. So where did this leave us? In limbo, it seems. Our client had no right to prevent the lead from selling, no right to make the lead (or its successor) enforce the loan, and no certainty that a court would allow the client to seek collection directly against the borrower, if the client was willing to make the effort to try. A most unsatisfactory answer.

Conclusion

Clearly, it would be in the interest of the participants to have rights that are better defined. As the cases show, the expectations of the participant differ from those of the lead in certain ways. The lead expects that the existence of the participation imposes an extra burden on the lead only in that it must account for and pay over to the participant the participant's pro rata share of amounts collected by the lead on the loan. From the lead's perspective, the presumption is that the lead has no other duties to the participant. Additional responsibilities will exist only if expressly agreed to in the participation agreement.

The participant's expectations appear to include that the lead has underwritten and will administer the loan in a reasonably prudent fashion, as behooves a commercial lender in respect of loans it makes. The participant may also expect that it will be treated as a creditor of the borrower – that it isn't acquiring a "shadow" interest confined only to rights against the lead to the extent that the lead actually gets paid by the borrower. But the participation agreement seldom contains anything suggesting that such expectations are part of the deal. The cases show that these differing expectations have led to participants suing the lead (or its receiver). Such conflicts might be avoided (or at least made more rare) if the parties' expectations were more in sync, which could be achieved by a more comprehensive participation agreement.

Accordingly, we believe that when a participation is being negotiated and a participation agreement being prepared, the parties should consider and address in the document the following:

1. Defining the interest being sold and clearly state that the participant is not making a loan to the lead and will only receive payment if it comes from borrower or collateral or guaranties securing borrower's obligations to the lead. If the participation interest contains unusual features, such as "last-in" or "last-out", or is otherwise on any footing other than a straight pro-rata share of all payments received, that should also be clearly stated. If the participant may assign or subdivide its interest, that should be stated.

2. Acknowledging that the participant did not rely and has no right to rely on the lead's due diligence, credit review or underwriting. But the participant should be assured that the lead has not knowingly misrepresented or omitted any material facts. And the lead should provide, and give assurances, that it has provided complete and correct copies of the loan documents, including UCC filings and judgment, lien and tax lien searches, and any information provided to the lead by the borrower. It is not reasonable for the participant to take documentation risk unless it has been given the documents.

3. It should be clear that if the lead becomes insolvent or a receiver is appointed for the lead, or if the lead becomes unable or unwilling to administer the loan, then participant has the right to collect its proportionate interest in the loan directly from the borrower.[105]

4. The collateral in which the participant is entitled to share should be clearly described and should include setoffs against deposits or other property of borrower held by the lead, *unless the parties explicitly agree otherwise*. If there are assets of borrower which are not part of the collateral for the participated loan, the participation agreement should address whether, and under what conditions, those other assets may become collateral for other extensions of credit by the lead (or the participant) to the borrower and not be required to co-secure the participated loan.

5. Unless the parties agree otherwise, the standard of care to be exercised by the lead should be stated as the care which a reasonably prudent commercial lender would exercise in like circumstances and should include a disclaimer of any fiduciary relationship. In this regard, we note that some participation agreements describe the lead's responsibility in administering the loan as requiring the same level of care that it uses to administer its other loans. In our view, that standard is a potential nightmare in litigation because it could open the door to extensive discovery by a participant as to how the lead has handled its other loans. Use of a "reasonably prudent commercial lender" standard may help prevent such a fishing expedition.

6. The agreement should specify a listing of any actions which the lead may not take without the participant's approval. Typically, these would include prohibitions such as the following:

   - extension of maturity dates;
   - decreases of interest rates;
   - forgiveness of principal, interest or fees;
   - changing scheduled payment dates;
   - waiving mandatory prepayments; and
   - waiving events of default.

7. The agreement should state whether the lead has sold or is free to sell additional participations in the loan, and whether the lead will nevertheless continue to hold at least a specified percentage or amount of the loan until maturity. It should also state whether the lead can grant different consent and approval rights to other participants.

8. The agreement should state whether the lead has a right to repurchase the participation interest if the lead requests a consent or approval and the participant refuses.

9. If the agreement includes a provision requiring the lead to maintain a specific minimum percentage or amount of the loan, or restricting granting of other participations, then the participation agreement should also give the participant a right to "put" the interest back to the lead if the lead breaches any such obligation.

Participations offer a convenient way for lenders to diversify their portfolios and share opportunities, but the parties need to understand what the relationship is and is not. Thoughtful discussion of the issues and careful drafting will lead to clearer understanding and expression of the parties' agreements, resulting in fewer disappointed expectations and consequently fewer disputes when problems arise.

> *The difference between the right word and the almost right word is the difference between lightening and a lightening bug.*
>
> \- Mark Twain

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ARE FACTORING TRANSACTIONS "TRUE SALES"? SHOULD FACTORS CARE?[106]

By Haywood A. Barnes

This article was written in response to questions from my factoring clients regarding whether factoring transactions constitute "true sales" of accounts receivable and, if not, why and what are the ramifications. A number of very good articles on this topic have been written over the years.[107] What I have tried to do a little differently here is explain in some detail how factoring transactions work and then explain and apply true sale analysis to those details. As you will see, I take the position that factoring transactions in almost all instances would not withstand true sale scrutiny, but I also take the position that, in most cases, the lack of a true sale should not be an issue for factors.

I. Factoring Basics

To lay the groundwork for this article, I need to describe how factoring transactions work. I will do this by describing the two principal varieties of factoring transactions: Notification Factoring *Without* Advances and Notification Factoring *With* Advances.

A. Notification Factoring *Without* Advances

In this type of transaction, the factor purchases accounts receivable from the seller (sometimes called the "client" by the factor) with full notification to each account debtor (sometimes called the "customer" by the factor). In some transactions of this type the factor purchases all of a client's accounts, and in others the factor purchases only the accounts a client offers for sale.

The typical "purchase price" of an account sold in this type of transaction is the net invoice amount (i.e., the gross invoice price less discounts for early pay and other amounts deducted by the seller), less the factoring "commission" on such account. The factor collects the factored accounts and "pays" the purchase price to the client by remitting those collections to the client on a periodic basis, less any obligations owing by the client to the factor and any reserves established by the factor.

A client's main reason for entering into this kind of transaction is the factor's assumption of the customer's credit risk on approved accounts. Approved accounts (sometimes called "factor risk" or "warranted" accounts) are accounts on which the factor has assumed the risk that the customers will not pay due solely to their financial inability. If a customer does not pay an approved account by its due date solely due to financial inability, the factor "matures" the account - i.e., it pays the purchase price of the approved account to the client.

Approved accounts become unapproved accounts (sometimes called "client risk" accounts) if the client breaches any of the various reps, warranties and covenants contained in the factoring agreement regarding the approved accounts, including the representation and warranty that the accounts are upon purchase, and will continue to be, owing without "dilution" (i.e., customer disputes and deductions).

Factors charge a factoring "commission" on each factored account, the amount of which varies greatly but usually is in the neighborhood of 0.5% to 1.5% for customers with good credit. The factor deducts such commissions from collections on the factored accounts, but commissions are payable whether or not there are sufficient collections from which to deduct them.

Factors also charge interest on the client's obligations owing to the factor, but since the amount of such obligations is relatively small in a transaction without advances, interest charges in such a transaction are usually small. Larger amounts of interest are more typical in Notification Factoring With Advances transactions as discussed below.

Factoring agreements typically contain few reps and warranties outside of the standard reps and warranties regarding a