NBA LEGAL CORNER

PARTICIPATON AGREEMENT OR DISGUISED LOAN

The Nebraska Supreme Court recently rendered an opinion in the case of *Community First Bank v. First Central Bank McCook,* 310 Neb. 839 (2022), involving the issue of whether a contract between two banks was a participation agreement or whether it created a debtor – creditor relationship (loan) between the two banks.

In *Community First*, the lower court had granted the motion of First Central for summary judgment and dismissed Community First's complaint in which its "causes of action" were all based on a claim for breach of contract. The Supreme Court, concluding that the contract between the parties was ambiguous, determined that a genuine issue of material fact existed regarding the provisions of the contract between the parties as to whether their contract was a participation agreement or a loan and that neither party was entitled to judgment as a matter of law at that stage of the proceedings. Accordingly, the Supreme Court reversed the lower court order granting summary judgment in favor of First Central and remanded the cause to the district court for further proceedings.

Community First alleged that First Central approached it in 2017 "about providing $300,000 in financing." The offer was accepted, and the parties entered into a contract dated June 1, 2017, pursuant to which Community First's interest matured on August 1, 2017. The contract between the parties consisted of a document entitled "Participation Agreement," into which a June 1, 2017, letter between the parties was incorporated. Four separate extensions of the maturity date were requested and granted, the last of which extended the maturity date to December 15, 2018. Following maturity, payment was requested by Community First and Community First alleged that First Central refused to pay what was owed under the contract and its extensions.

The arrangement between Community First and First Central related to the refinancing of a $861,000 loan of a customer of First Central which would have allegedly exceeded the regulatory lending limit of First Central. Community First claimed that the June 2017 contract created a debtor-creditor relationship between the parties, whereas First Central contended that the Agreement was a participation and not a loan. Subsequent to the maturity date of contract, First Central's borrower filed bankruptcy.

The court acknowledged that Nebraska case law does not appear to address the standards for determining whether a given arrangement constitutes a true participation agreement, or whether it is instead a disguised loan.

The Supreme Court analyzed the traditional components of a loan participation in which "the wide spread majority" of cases hold that the participated loan device results in the sale of the designated percentage of the loan to the participating bank with the lead bank acting as the participant's agent to collect and forward the appropriate repayments and to service the loan.

The court further noted “participations are not loans; they are contractual arrangements between a lender and a third-party, in which the third-party, or participant, provides funds to the lender…the lender in turn uses the funds from the participant to make loans to the borrower.”

The court further indicated:

> “In the typical participation, the lead lender transfers to the participant not only the benefits to be received from a share in the underlying loan (i.e. a *pro rata* share in the principal and interest payments) but also the risk of the borrower’s default. The lead lender makes no warranties or guarantees about the borrower’s ability to repay the loan or about the worth of the collateral in the event of default. If the borrower does default, the participant is entitled to a *pro rata* share of any monies received upon liquidation of the collateral, but it has no right of recourse against the lead lender.”

In distinguishing between a true participation and a disguised loan, the court cited the following factors that indicate that a transaction is a true participation:

1) money is advanced by participant to a lead lender;
2) the participant’s right to repayment only arises when the 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.

By contrast, the court noted the following factors that indicate that a purported participation may in fact be a disguised loan:

1) guarantee of repayment by the lead lender to a participant;
2) participation that lasts for a shorter or longer term than the underlying obligation;
3) different payment arrangements between the 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.

The court further held “Factors which may cause a transaction to be other than a true loan participation include anything that indicates the participants are not subject to the normal risks of ownership, such as guaranteed returns by the lead institution, or required repurchase agreements.”

The Supreme Court ultimately determined that the contract relating to the transaction between the parties was ambiguous. While several provisions of the contract tended to support a determination that the agreement included the features of the participation, other provisions, such as “guarantee of repayment by the lead lender to a participant” and especially “participation that lasts for a shorter or longer term than the underlying obligation” may indicate the transaction is a disguised loan.

In *Community First*, discrepancies between the “maturity date” for Community First’s funding commitment (August 1, 2017, later extended to December 15, 2018) and First

Central’s funding obligation (December 15, 2030) created an ambiguity within the contract regarding the term of the underlying indebtedness.

Being unable to discern whether the maturity date was August 1, 2017 (later extended to December 15, 2018) or December 15, 2030 and whether First Central was guaranteeing payment to Community First of all principal and interest on August 1, 2017 (later extended to December 15, 2018), independent of the First Central borrower’s obligations and performance under the promissory note, the Supreme Court determined that genuine issues of material fact existed and remanded the action for further proceedings.

Participation agreements have historically been the source of extensive litigation and lenders should exercise due diligence in preparing contract documents and documenting these types of transactions.