UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF RHODE ISLAND

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In re: :

FELICITY ASSOCIATES, INC. : BK No. 95-11101
Debtor Chapter 11

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TITLE: *In re Felicity Assocs., Inc.*

CITATION:

DECISION AND ORDER

APPEARANCES:

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BEFORE ARTHUR N. VOTOLATO, United States Bankruptcy Judge

Heard on April 4, 1996, on the Objection of Citizens Trust Company to the Debtor's Disclosure Statement and Plan of Reorganization. At issue is the effect of a "Participation Agreement," so-called, between Citizens and Marie Porcaro ("Porcaro"), vis-a-vis the Debtor's classification of Porcaro as the holder of a secured claim in this case. The Plan treats Porcaro as a secured creditor based on her subordinated participation interest in a loan between Citizens and the Debtor, and places her in a private sub-class under the plan. Porcaro is a guarantor of said loan, together with her sons Patrick and Vincent Porcaro, the Debtor's principals.[1]

BACKGROUND

On the date of filing of this Chapter 11 case (May 8, 1995), Citizens was owed $500,000 on a secured line of credit. By December 1995, the Debtor had reduced the secured debt to $286,000 by conducting an orderly liquidation of old inventory. This debt reduction during the Chapter 11 apparently was not good enough, however, and Citizen's brought actions in the state court against Marie Porcaro and her two sons. After being sued as a guarantor, Marie Porcaro entered into an

[1] Marie Porcaro is the majority sharholder of the Debtor corporation, with 60.25% of the stock. Her sons, Vincent Porcaro and Patrick Porcaro, own 19.87 % and 19.88% of the stock, respectively.

"Option Agreement to Purchase Participation Share" with Citizens, whereby she paid $200,000, and Citizens agreed to assign all of its right, title and interest in the loan to Porcaro, once the loan was paid down to $200,000. The Agreement also provides *inter alia* that:

> (iii) [Citizens] shall have the *sole and absolute right* to *manage, perform* and *enforce* the terms of the Agreement, and *to exercise* and enforce *all* provisions, *rights* and remedies exercisable or enforceable by Bank *in connection with* the *Debtor's bankruptcy proceeding* in *Bank's sole and absolute discretion. . . .*

*See* Citizens' Ex. 1, at 3 (emphasis added).

Citizens objects to approval of the Disclosure Statement on the following grounds:

(1) That the Debtor has attempted, improperly: (i) to rewrite the Agreement between the Bank and Marie Porcaro by treating her as a secured creditor; (ii) to place Porcaro in a separate secured creditor sub-class, in order to gerrymander an affirmative vote on the Debtor's Plan; and (iii) to pay the Bank less than that to which it is entitled. Citizens also complains that the Disclosure Statement fails to adequately describe the Debtor's financial performance for the years ending December 31, 1994, and 1995, as well as other

information material to the merits of the proposed Plan.

The Debtor argues that the agreement between Marie Porcaro and Citizens is not really a "participation agreement," but rather, that the effect of the document is to make Marie Porcaro a subordinated, contingent, secured creditor in the amount of $200,000. For the reasons discussed below, we reject all of the Debtor's arguments and deny approval of the present Disclosure Statement.

DISCUSSION

It has become standard Chapter 11 practice that "when an objection raises substantive plan issues that are normally addressed at confirmation, it is proper to consider and rule upon such issues prior to confirmation, where the proposed plan is arguably unconfirmable on its face." *In re Main Road Properties*, 144 B.R. 217, 219 (Bankr. D.R.I. 1992) (*citing In re Bjolmes Realty Trust*, 134 B.R. 1000, 1002 (Bankr. D. Mass. 1991)). For a reorganization plan to be confirmed, "it must comply with all the requirements of Chapter 11, as provided in 11 U.S.C. § 1129(a)(1)." *See In re Smithfield Estates, Inc.*, 52 B.R. 220, 222 (Bankr. D.R.I. 1985). While the question presently before the Court appears to be a confirmation issue, it is one that we feel comfortable addressing at the disclosure

hearing.

The Debtor and Citizens agree that in a true participation agreement the lead bank is charged with collecting the debt, including the filing of a proof of claim in bankruptcy, and perfecting its claim against the borrower. *See Mason & Dixon Lines, Inc. v. First National Bank*, 86 B.R. 476, 479 (D.N.C. 1988), *aff'd* 883 F.2d 2 (4th Cir. 1989); *First State Bank v. Towboat Chippewa*, 403 F.Supp. 27, 34-35 (N.D. Ill. 1975). It is also agreed that because the participant's relationship is with the bank and not with the debtor, the lead bank, *and not the participant* is considered the creditor. (Emphasis added.) *See Hibernia Nat'l Bank v. Federal Deposit Ins. Corp.*, 733 F.2d 1403, 1407-09 (10th Cir. 1984). However, where the Debtor and Citizens part company is the nature of the agreement between the Bank and Marie Porcaro.

The Court in *Mason Dixon* listed two standard earmarks of a participation agreement: (1) that the lead bank retain the collateral, in its name; and (2) that the lead bank service the loan. 86 B.R. at 478. The subject agreement, in paragraph "iii" quoted *supra,* clearly fulfills these requirements.[2]

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[2] It appears that the definition of a participation agreement is quite fluid. One commentator has stated that the participation agreement has "no specified or standard form, no

Accordingly, we conclude that this is a true participation agreement to which Marie Porcaro is a party, and that she is not a creditor in this case, as the Debtor proposes to treat her under the Plan. The request for approval of its Disclosure Statement, as proposed, is DENIED, and the Debtor is allowed fifteen (15) days within which to file an Amended Plan and Disclosure Statement.

The Debtor argues, alternatively, that if Marie Porcaro had paid $200,000 under her guarantee, she would be "*automatically entitled*" to be subrogated to the rights of Citizens to the extent of her payment, and that the participation agreement only mirrors her rights under § 509. This argument is immediately defective because Ms. Porcaro has *not* met her obligation as a guarantor, nor has she offered to do so. Suffice it to say that Marie Porcaro's entitlement to equitable consideration and subrogation, on the facts of this case, is not an option. *See In re Stratford Lamps, Inc.*, 120 B.R. 31, 34 (Bankr. W.D. Pa. 1990) (holding that "[i]n order for subrogation to apply, the equities of the party seeking subrogation must be superior to those of other claimants"). In

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statutory characteristics, and often operates in conjunction with other documents . . . ." Alan W. Armstrong, *The Evolving Law of Participations*, R175 ALI-ABA 255 (April 2, 1992).

this insider case, the equities do not even begin to favor either the Debtor or Marie Porcaro.

Enter Judgment consistent with this order.

Dated at Providence, Rhode Island, this 3rd day of June, 1996.

/s/ Arthur N. Votolato

Arthur N. Votolato
U.S. Bankruptcy Judge