

LOAN PARTICIPATIONS

- LEGAL & REGULATORY ISSUES -

Loan participations are invaluable tools in the banking world. The key to a successful loan participation is for the parties to fully understand the mechanics of the loan and the terms of the participation agreement. Because there is a lack of “standardized” participation agreements in the industry, many issues must be considered prior to entering into a loan participation transaction.

REGULATORY ISSUES

Recently, there has been an increase in troubled loan participations which has led federal and state banking regulators to instruct examiners to look more closely at loan participation files and participation agreements.

It is key for banks to have policies and procedures in place to deal specifically with loan participation transactions. These policies should address matters such as:

- The authority needed to enter into a participation agreement;
- The independent credit analysis needed to review the loan;
- The role of the bank board of directors;
- Appraisal guidelines;
- Record and maintenance loan monitoring procedures; and
- Collection procedures.

With respect to credit analysis, banks purchasing a loan participation should perform the same degree of independent credit analysis as if it originated the loan itself. Participating banks should obtain and review all documentation necessary to conduct such an analysis. Regulatory authorities will review a bank’s credit analysis to ensure that the bank made its decision based on a prudent and independent review of all the relevant documentation. A participating bank should not rely solely on the lead bank’s analysis.

Regulatory authorities will also look at the participating bank’s records to determine if the bank is monitoring the loan properly, so it is important to maintain accurate and up-to-date records.

Additionally, regulators will look closely at participation transactions where a bank purchases a participation loan from an affiliate. In these situations, banks must comply with specific rules under the Federal Reserve Act. Using an affiliation loan participation to avoid legal lending requirements is a violation of the Federal Reserve Act; therefore regulators want to limit the amount of affiliation loan participations. Regulatory authorities will look closely at the transaction to make sure that the participating bank purchases the loan from the affiliate prior to the affiliate’s extension of credit to the borrower.

Lastly, regulators do not look favorably on banks that sell or purchase 100% loan participations due to increased legal and compliance risks for both parties. Regulators are

weary of these types of transactions because the lead banks have no stake in the loan. Having policies and procedures in place to manage this type of participation would prove helpful and efficient at review time.

CLASSIFICATION ISSUES

It is important to determine at the outset of the transaction how the relationship between the lead bank and the participating bank will be classified. This will have an impact on the structure of the participation agreement as well as the liabilities of the parties.

Types of participations may be classified as sales, loans, trusts, securities, partnerships, etc. It is important to know that participations classified as anything other than a sale creates issues and risks for both the lead bank and participating bank and should be avoided. For example, if the transaction is classified as a loan, a participating bank would be viewed as an unsecured creditor unless it independently secures its position. Trusts or a securities participation transaction creates heightened standards of care and fiduciary duties between the lead and participating banks that should be avoided.

The most desirable situation is a sale or purchase relationship between the lead bank and the participating bank. It should be very clear in the participation agreement that the transaction is a sale and should contain no language indicating that the lead bank is a “lender” or that the participating bank is a “borrower.” Additionally, the participation agreement should specify not only the allocation of payments, losses and expenses (e.g., pro-rata, LIFO, FIFO, etc.), but also the participating bank’s right to perform its own independent review of the transaction.

OBLIGATIONS OF THE LEAD BANK

A lead bank has many obligations to perform in a loan participation, which are enumerated in the participation agreement. These obligations exist whether 10% or 100% of the loan is sold. The lead bank collects the payments from the borrower and remits to the participating bank its proportionate share of the payments pursuant to a specific repayment outline.

The lead bank has an obligation to notify the participating bank if there are any changes in the following:

- The financial condition of the borrower;
- Any material changes in the value or lien status of the collateral securing the loan;
- Any requests for changes in the terms of the loan; or
- The occurrence of any event of default.

The lead bank has a duty to use its best efforts and exercise the same care in the administration of the loan that it would in the handling of its own loans. This means that if the borrower would default on the loan, even if the lead bank has sold 100% of the loan to a participating bank, the lead bank must use sound business judgments to enforce the note and the other loan documents to avoid any losses. However, because many participation agreements are so poorly drafted, they are subject to litigation. Both lead

and participating banks should be sure that their participation agreement fully outlines the roles of the parties and the remedies for non-compliance with such roles.

REPRESENTATION & WARRANTY ISSUES

The participation agreement should specifically cover matters such as affirmative representations and warranties and applicable disclaimers. Participating banks are usually required to represent, warrant, and acknowledge that they have received and made a complete examination of the loan documents, as well as having performed their own independent credit analysis and evaluation of the loan transaction without any reliance upon the lead bank.

Lead banks should be sure to include disclaimers in the participation agreement stating they have no responsibility for any statement, warranty, or representation made in any document delivered in connection with the loan. Additionally, the participation agreement should contain an acknowledgement that the lead bank has made no guaranty of repayment, and the participating bank must look solely to the borrower and the collateral for repayment of the loan.

A common misconception in loan participations is that the lead bank is obligated to buy the participating bank out of their share of the loan in the event the borrower defaults. A lead bank may do so, but there is no, and can be no, obligation to repurchase the loan. An obligation to repurchase the loan would turn the sale of the participation into a participation with recourse and run afoul with the aggregation rules of Minnesota Statutes § 48.24. If the loan does go into default, the participating bank goes along for the collection ride.

INTERCREDITOR ISSUES

As a general rule, if the participating bank is unhappy with the administration of the loan, they do not have any remedies against the lead bank or borrower, unless expressly included in the participation agreement. The lead bank has a duty to administer the loan in accordance with “sound and prudent banking standards”.

Although a performing loan does not create many intercreditor issues, a troubled loan presents many issues between a lead bank and participating bank. Potential claims against the lead bank could include:

- Breach of contract;
- Fraud;
- Misrepresentation;
- Negligence;
- Breach of fiduciary duty;
- Breach of good faith; and
- Conflict of interest and self-dealing.

A well drafted participation agreement helps avoid many of these claims and resolve conflicts that arise between the parties.

Should the borrower default under the loan, generally the lead bank must pursue a method of recovery that it would normally choose and, in most cases, the participating bank has no say in post default collection remedies. Whether or not the chosen collection remedy is a success, or whether the participating bank agrees with the method of recovery, it does not create a right of recourse against the lead bank for the participating bank. Absent fraud or other egregious conduct, the participating bank is bound by the actions and choices of the lead bank.

Notwithstanding, conflict among parties to a loan participation may still arise in connection with the strategies upon a default by the borrower. One party may prefer a workout or forbearance arrangement while others prefer collateral liquidation. As stated above, most participation agreements give the lead bank most, if not all, of the control over the administration of the loan as well as the course of remedy upon default.

Some agreements use a majority rule process, most often when there are several participating banks. One of the major issues with this process is the potential for delays and impasses at the time when swift decision making is imperative. Also, some participation agreements require unanimity among participating banks in connection with default situations.

Well drafted provisions regarding remedies in the event of a default by the participating bank can cure many intercreditor issues. To avoid deadlocks or conflict, language may be used in the participation agreement allowing the lead bank to exercise specific remedies or buyout options in the event the loan participants are unable to agree. Other remedies in a default situation include:

- Suspension of any consent rights granted to a participating bank during the duration of a default;
- Payment of interest at specified rates if the default is monetary;
- Suspension of a participating bank's right to receive its share of any payments with respect to the underlying loan for the duration of the default; or
- Subordination of a participating bank's interest in the loan to other lenders.

CONCLUSION

There are many benefits to entering into a loan participation transaction. But there are many issues and risks that must be addressed as well. A well-drafted participation agreement setting forth the terms and conditions of the transaction, as well as the expectations of the parties, is the perfect vehicle to accomplish the goals of all parties involved. Fully understanding the participation arrangement and obligations of the lead bank and participating bank will decrease the likelihood of a conflict amongst the parties and avoid possible litigation in the future.