



As seen in...

BankNews

Reprinted with permission of BankNews Media. Contents of BankNews are, and remain, the property of BankNews, Inc.

Participations — Avoiding Problems in the Making

Throughout the years, I have had the privilege of working with many clients who were either a lead bank or a participant in a participated loan. Invariably, the work involved a troubled loan. Unfortunately, in many cases, there was friction between the lead bank and its participants over any number of issues. Too often, the lead bank and participants were not fully aware of the various terms and provisions of their loan participation agreements, which can vary widely from loan to loan.

When and Why to Participate

There are several good reasons to participate a loan. The most common is that the lead bank or participant is presented with a lending opportunity that exceeds its legal lending limits. Finding a good participant partner makes sense. Another good reason, but perhaps more rare, is when a bank is presented with a lending opportunity that is outside of its scope of expertise or knowledge of the borrower's industry. In that case, a bank may bring in a lead lender with the capability to manage the credit and monitor the borrower's performance. Yet another good reason may be a common relationship between a group of lenders and a specific borrower, all of whom have had experience working together on various loans.

At the same time, there are a few bad reasons to participate a loan, often leading to trouble. For instance, a drive for loan growth is often a reason why banks become participants. If the underwriting process is insufficient to filter risks, or if the participating bank does not have a good understanding of the borrower, collateral or business, the participant may be shackled to a costly troubled loan without the means to control its own destiny. This is especially true with out-of-market loans involving borrowers and collateral in other cities and states. The distance, alone, can impede the participant's ability to monitor and control its risks. A desire to share risks on a credit is another reason banks may participate a loan. In some cases, the desire may be motivated by risk factors that would ordinarily prompt a decision to deny credit. In other words, the desire to share risk is actually a desire to share a bad loan.

Rights and Duties of the Lead Bank

Regardless of when and why a bank participates in a loan, the lead bank and its participants must understand all of the terms and provisions they wish to include in the participation agreement and carefully document them. Although there are various forms of participation agreements available through software vendors, most are drafted by lead banks and their attorneys. Therefore, they vary widely from form to form.

The rights and duties of the lead bank typically fall into several categories — contractual, fiduciary, accounting and management. Contractual duties are ordinarily those that are specified in the participation agreement itself. But courts have also held that the terms of a participation agreement may also include terms from the participation commitment letter, participation certificate or other documents associated with the loan.

For instance, in the 1995 case of *North American Savings Bank v. RTC*, the Resolution Trust Corp. was appointed conservator of a failed bank that participated in a loan held by North American Savings Bank, and sued to enforce a letter agreement guarantying the first \$3 million in losses of the participant. The Eighth Circuit Court of Appeals ruled that the loan participation agreement, letter agreement and loan participation certificate were all intended by the parties to be part of one single agreement, and were not barred by the parole evidence rule.

A well-drafted participation agreement should address the rights and limitations of the lead bank to take the following actions, either with or without participant approval:

- Changes to the terms or amounts of commitments.
- Modifications of loan terms or loan documents.
- Increases, advances or commitments for additional loan amounts.
- Consents to changes in capitalization, capital structure or corporate structure of borrowers or guarantors.
- Consents to other changes in the business, financial condition or operations of borrower or guarantors.
- Waivers or modifications of borrower reporting, DSCR or performance requirements.

- Reductions, modifications or forgiveness of borrower's payment obligations.
- Forbearance, postponement or waiver of payment requirements or default of borrower.
- Acceleration of the loan, foreclosure, commencement of litigation or other enforcement actions.
- Releases, subordinations or substitutions of collateral.
- Releases of guarantors.
- Other terms of settlements with borrowers or guarantors.
- Terms and conditions for the marketing, sale or disposition of any collateral.

All parties should carefully review their respective rights and limitations. A participation agreement should also define the specific duties (as opposed to rights) of the lead bank. These duties will generally include:

- The obligation to administer, service and enforce the loan.
- A duty to account for payments, recoveries and distributions.
- Requirements for reporting to the participants on the status of the loan.
- A requirement to provide loan documents to the participants.
- In rare cases, a duty to repurchase a participation interest.

It is this latter duty that causes the most confusion among the parties. Participants often think that a lead bank has a duty to repurchase their participation interest at the first sign of trouble. Obligations to repurchase rarely exist in participation agreements, although many agreements give the lead bank a right of repurchase. Courts have held that an obligation to repurchase must clearly appear in the participation agreement to be enforceable.

Rights and Duties of the Participants

Conversely, a participation agreement should define the participants' rights and duties as well. Typical rights of a participant will include:

- Terms requiring the consent of participants for decisions and actions of the lead bank.
- The right to receive accountings for payments, recoveries and distributions.
- A right to assume the duties of the lead bank where the lead bank is unable to do so.
- Any right to enforce repurchase of the participation interest (if required).

Similarly, typical duties of a participant will include:

- A duty to advance the participating interest in the loan.

Participants often think that a lead bank has a duty to repurchase their participation interest at the first sign of trouble. Obligations to repurchase rarely exist in participation agreements.

- Any duties to make subsequent advances during the term of the loan.
- Duties to pay a proportionate share of fees, costs and expenses.

In addition to the rights and duties of the lead bank and participants, there are a number of other terms that require special attention. Parties often overlook these terms in their review of participation agreements. These include:

- Allocation of loan fees, points or other incidental fees.
- Allocation of decision-making authority based on shares owned by the lead bank and participant.
- Recourse or remedies given to participants for breach of the participation agreement, negligence or failure to act on the part of the lead bank.
- Distributions of payments and recoveries.
- Limitations on liabilities of the lead bank.
- The acknowledgement and consent of participants with respect to other loans held by the lead bank with respect to the same borrower.
- Reimbursement of expenses of the lead bank.
- Indemnification of the lead bank as to authorized actions.
- Disclaimers or waivers of liability of the lead bank.
- Rights of the participants to substitute or assume the rights of the lead bank. **BA**

Next month, the author continues his discussion of the perils of loan participations with communications aspects, accounting and distributions, and examples.