



COMMERCIAL

The Perils of Participation

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Loan participations have become an increasingly common feature of the lending landscape for numerous reasons. From the originating/lead lender's perspective, a loan participation allows the lender to lay off a portion of the risk of an uncomfortably or impermissibly large loan or overly broad lending relationship without giving up control of the loan or the relationship and/or to increase lending volumes and associated origination and servicing income. From the participating lender's perspective, a loan participation provides an opportunity to diversify its portfolio to different borrowers, industries, locales and product types without the need to invest in business development, new offices and additional expertise.

In a loan participation, the lead lender extends credit to the borrower and later sells out undivided portions of its loans to other lenders; primarily traditional banks (participants). The loan contract with the borrower is signed only with the lead lender. The lead lender then enters into a separate participation agreement (Loan Participation Agreement) with the participants. Thus, the borrower's and participants' relationships are solely with the lead bank, and there is no direct relationship between the participants and the borrower or the participants themselves, if more than one.

The typical Loan Participation Agreement will confirm the sale of the participation interest(s) and appointment of the lead lender

to collect, account for and remit payments in connection with the loan and to manage the relationship with the borrower including enforcement of the loan if required. Most Loan Participation Agreements further provide some mechanism for consultation and collaborative decision making among the owners of the loan on limited issues (reduction in amounts owed, waiver of security or release of guarantors). However, many Loan Participation Agreements fail to fully address the issues that arise out of the participants' lack of direct contact with the borrower and control of the lending relationship and the separate relationship among the lead lender and the participant(s). All too often, important issues including those relating to conflict of interest, scope of authority and duty of care, impasse resolution and assignment are inadequately addressed or entirely omitted thereby creating ambiguity and risk for both the lead lender and the participant. This tendency is ironic given lenders' typical dealings with their borrowers in which they "worry every little detail" and often "document the deal to death".

Conflict of interest is often one of the greatest perils facing the participating lender. Commonly, the lead lender has a broad relationship with the borrower and/or its affiliates and is selling participation interests in one or more but not all of the lead lender's loans to the borrowing group. Several questions arise in these situations.

...Perils continued on page 51

Is the lead lender obligated to fully disclose all such relationships to the participant? Must the lead lender advise the participant of any adverse developments relating to the other loans, affiliated borrowers or information obtained in connection with the other loans? Should the lead lender consider the impact of its actions or potential actions relating to other loans to the borrower group upon the security for and collectability of the participated loan? These conflicts can strongly influence the lead lender's attitudes and decisions regarding administration of the loan particularly with regard to extensions, workouts and loan enforcement alternatives. It is not uncommon for the participant to learn belatedly that lead lender has improved its position with respect to its other loans to the borrower by obtaining payment of all available funds and/or liens on all available assets leaving nothing to shore up the participated loan just when additional support is most needed.

Inadequate definition of the lead lender's scope of duties and/or authority to act or refrain from acting can be a source of controversy and risk when the loan goes bad or the lead lender is in trouble. Is the lead lender obligated to pursue enforcement or does it have discretion to forbear? Can the lead lender grant extensions, capitalize delinquent payments, waive collection of costs, modify the loan documents, accept additional collateral, make protective advances, release guarantors, etc. Is the lead

lender a fiduciary with respect to the participant's interest in the loan such that the lead lender must set aside its conflicts and act in the best interests of the participant even if to the detriment of the lead lender? Are the funds collected by the lead lender from the borrower required to be held in a segregated or trust account pending disbursement? Will the funds held by the lead lender be safe from claims of the creditors of the lead lender in the event of its insolvency?

Even when the lead lender's duties and scope of authority are clearly defined, the lead lender and the participant risk finding themselves at an impasse as the participant's consent will likely be required for specified actions such as acceptance of a deed in lieu of foreclosure, release or waiver of collateral or guarantors, acceptance of partial payment and the like. The simplistic resolution mechanism included in many Loan Participation Agreements allowing either party to buy out the other party's interest at par is unhelpful in default situations. What happens then? Do the parties try to wait each other out or seek costly and untimely judicial intervention? Who is responsible for the payment of those costs?

With ever increasing frequency, one or more of the lenders at the outset of the participated loan will need to assign its interest in the loan or cease to exist either through consolidation or closure by the FDIC or another governmental agency. Is consent required from the other lender(s) to a voluntary transfer of

a lender's interest? Can the role of "lead lender" be transferred—is consent required? Must consents be reasonably provided or is consent discretionary? What are the successor lender's rights under the Loan Participation Agreement? Does the successor lender merely have an economic interest but no right to participate in decision making?

All of the foregoing questions and situations, and the significant risks arising therefrom, can and should be dealt with at the outset of the participation relationship. Candid discussion among the lenders and clear drafting of the Loan Participation Agreement up front will eliminate many of the noted perils of participation.



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