Michael A. Campbell is chair of the creditors' rights, loan enforcement and creditor bankruptcy representation practice group with Polsinelli Shughart PC in St. Louis. Contact the author at 314-552-6805 or mcampbell@polsinelli.com.

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Participations — Problems in the Making, and How to Avoid Them, Part II

The most critical component of the relationship between the lead bank and its participants, and the source of most disagreements, is communication. A prudent lead bank will adopt the motto "early and often" in all of its communications with the participants. But it is helpful for a lead bank to understand the communications that it is required to give, and those that are discretionary.

Necessary or required communications will be those that are specified in the participation agreement. They may include the status of borrower performance, the status of collateral, reports and information from borrowers, and similar information. On the other hand, discretionary communications are those that are not required by the participation agreement, but which a prudent lead bank would give to participants. A prudent lead bank will follow the golden rule, and will communicate any information to the participant that the lead bank would want to know if it were in the shoes of the participant.

The form of communication is also important. A prudent lead bank (as well as a participant) will communicate in a form that memorializes all discussions and decisions. Although telephone and oral communications are important in reviewing critical issues, any critical communications and decisions should be documented in writing. Emails are generally sufficient for this purpose, but should be regularly printed and held in the loan files.

To illustrate this, imagine a telephone call in which a participant's loan officer authorizes a lead bank to release certain collateral and guaranties, but no written confirmation is given. Soon thereafter the loan officer leaves the employment of the participant. Within a few months the borrower stops making payments. The participant's president discovers, for the first time, that collateral and guaranties have been released. You can imagine the ending to this story.

In addition to the need to memorialize communications, there are some communications that may require written consent forms. A lead bank should always review the participation agreement to determine if it requires a written consent for a specific transaction. For instance, a loan advance or change in certain loan terms may require the signature of the participants.

Accounting and Distributions

Accounting for expenses and distributions can also be a source of conflict between a lead bank and its participants. Generally, the contractual terms of the participation agreement will govern the allocation of expenses and distribution of payments and recoveries. But this seemingly simple rule is subject to several exceptions and complications that a lead bank must carefully consider.

First, participation agreements that became effective in the first reporting period after Nov. 15, 2009, are subject to FASB 166. Under FASB 166, a transfer of a loan participation interest will only be recognized on the books of a lead bank where all distributions of cash flow strictly follow the proportionate interests held by the lead bank and each participant. (Otherwise, the financial asset will be recognized as remaining on the books of the lead bank notwithstanding the sale of a participating interest).

Second, a lead bank must carefully consider the issues that arise when it has multiple loans, lending relationships or collateral that are subject to participation interests. Consider the following examples:

Example 1 — A lead bank has three loans to a borrower, each of which is secured by separate collateral. One of the loans is the subject of a participation agreement with a participant, and the other two are held only by the lead bank. The lead bank enters into a settlement with the borrower that calls for payoff of the two loans held by the lead bank, but only a partial payoff of the participated loan. In this example, the lead bank must determine its rights and limitations under the participation agreement to "self-deal." It must also determine if cross-collateralization provisions in the loan documents would give rise to any requirement that the lead bank apply payoff funds to the participated loan, or perhaps maintain the existing collateral for the unpaid participated loan. Finally, the lead bank must determine whether, under the laws of its state, it has assumed a fiduciary duty to its participants that would require it to apply payoff funds to fully repay the participated loan.

Example 2 — Consider the same facts as in example 1, but instead of a settlement with the borrower the lead bank liquidates all collateral and must allocate this to the three loans. Here, the lead bank must not only look to the provisions of the participation agreement that govern the allocation of proceeds of sale of collateral, but it must also determine if cross-collateralization provisions in the loan documents would give rise to any requirement that sale proceeds be applied to the participated loan (or perhaps applied to all three loans on a pro rata basis). Yet again, the lead bank must also determine if, under state law, it has assumed fiduciary duties.

Example 3 — A lead bank has one loan to a borrower that is secured by collateral that is also pledged as collateral for a different loan to a different borrower. One of the loans is the subject of a participation agreement with a participant, and the other is not. The lead bank liquidates the collateral. Here, the lead bank's decisions are not only complicated by all of the same factors as in examples 1 and 2, but also by the issue of the priority of the security interests that are held by the lead bank with respect to each loan. If the lead bank applies sale proceeds to the unparticipated loan, the participants will argue that this application favors the lead bank in breach of its fiduciary duties to the participants.

Finally, the effect of the appointment of the FDIC as receiver for the lead bank or a participant can create yet another set of problems for the remaining banks. For example, if the lead bank is the subject of a receivership, a vacuum in the decision-making and administration of the loan will likely be created during the receivership administration (at least until the lead bank interest can be sold). The participation agreement may not adequately address the rights of the remaining banks to purchase the interest of a lead bank or participant that is the subject of an FDIC receivership. And, even if it does, the FDIC may be unwilling to recognize those rights of purchase under its statutory authority to repudiate contracts.

Even more dangerous is the FDIC's treatment of loan accounts and deposit accounts of a borrower. When the FDIC becomes the receiver for a failed lead bank, it (and the borrower) have a right to offset the borrower's deposit accounts against the loan account. However, the participants do not then have a right to receive distributions of their pro rata share of that offset. Rather, the participants must instead file a claim with the FDIC as receiver, thereby receiving only a fraction of their share of the offset (if anything).

Prudent lead banks and participants will carefully consider all of these issues before entering a participation. BN

This is the final installment of a two-part discussion of participations. See the October issue for part one or search "Participations" in the Reference Library under Topics A-Z at BankNews.com.