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Tax Cuts

How Generous Are They to Your Business?

Lending Law Update

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"Most participation agreements create a win-win situation for all the lenders, as well as, the banks' customer who gets the benefit of having greater relationship opportunities among a larger group of lenders."

Participations - We are all on the same team - aren't we?

Participation loans serve a vital role in commercial lending. They attempt to allocate risk and allow partial interests in various loans to be shared. In the typical context, a lead bank structures the loan as a sole lender. Simultaneously or subsequent to the making of the loan, the lead lender sells a portion of it to other banks under the terms of a participation agreement. A participant lender may receive a certificate evidencing its share of the loan. The rights and obligations of all parties are created under and controlled by the participation agreement.

In a perfect world, each lender in a participation performs the full amount of due diligence required to underwrite the loan on its own and has looked at all of the underwriting risks. Most participation agreements create a win-win situation for all the lenders, as well as, the banks' customer who gets the benefit of having greater relationship opportunities among a larger group of lenders.

However, when things go awry in the participation loan context, the terms and conditions found in the participation agreement provide the alternatives and remedies available for resolving various issues. In two recent cases, things did not go so well for the participant lenders because their rights and expectations were not clearly stated in the agreement.

In *LNV Corp. v. Branch Banking and Trust Co.*, 2018 WL 358070 (11th Cir. 01/11/18), the U.S. Court of Appeals for the 11th Circuit determined that a participant lender had failed to prove its expectation interest or the benefit of its bargain in connection with the write-down of two different credit facilities that were purchased by a lead bank. The case emanates from a Florida real estate venture that collapsed in 2005 along with the real estate market. The joint venture developer sank and the borrowers were pushed into default. The lead bank accepted a settlement that created a disproportionate return to the lead bank on one of the two credit facilities, leaving the participant to suffer a very large loss under the loan that it had purchased. The lesson to be learned from this particular case is that a participant needs to make sure, with reasonable certainty, that its return on investment is specifically stated in the participation agreement and that the ability of the lead bank, to either structure a work-out or settlement, is done with the affirmation of all participants. When the participation agreement provides extraordinary authority and control to the lead bank, a participant cannot complain nor prove that it was to get a benefitted bargain.

Another case dealing with failed expectations and/or returns on investment was litigated in *Community & Southern Bank v. First Bank of Dalton et al.*, 811 S.E.2d 490, 2018 WL 1080457 (Ga. Ct. App. 02/28/18). In that case, the Court of Appeals of the State of Georgia held that a state trial court had ruled incorrectly when considering how proceeds from the sale of certain real property following foreclosure should be distributed among the participant banks that held interests in the underlying loans. The issue centered on the rights of the lead bank to deduct its expenses before distributing proceeds to the other participants. The participants argued that all proceeds were required to be distributed to the participant banks, pro rata, based upon their ownership interest, without deduction for lead bank expenses. The Court articulated that when separate loans are secured by a single mortgage and the proceeds from the sale of the collateral are insufficient to satisfy the entire debt, in the absence of any other special agreement, the proceeds are entitled to be shared pro rata among the participant banks.

The foregoing two cases, and, of course, other precedential litigation, illustrate that lenders should be clear on the rights and expectations they have when entering into participation loans. Due diligence is required, especially by participant lenders, to make certain that the terms and conditions found in the participation agreement will protect them from loss and provide reasonable alternatives with their input vote should a default occur.