Banking & Financial Services Report

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Loan Participation Agreements: The Devil is in the Details

Loan participations can be an invaluable tool in the world of commercial banking, particularly for community banks, credit unions and any institution that either is looking at a transaction the size of which exceeds its legal lending limit, or wishes to spread the risk of a particular loan or relationship. The key to a successful loan participation—whether with one or several participating lenders—is that all parties to the transaction understand the mechanics of the inter-creditor relationship. Because the industry has yet to develop a "standardized" participation arrangement, many issues should be considered before entering into a loan participation.

Credit Analysis

Any institution that is contemplating purchasing a participating interest in a loan should perform the same degree of independent credit analysis as if it originated the loan itself. All too often, the participating lender(s) will rely solely on the lead lender to determine the creditworthiness of the borrower and/or project. Participating lenders should obtain and review the necessary documentation from the lead lender necessary to conduct such an analysis.

Classification Issues

Typically, a participation transaction is classified as a sale in which the lead bank is "seller" and participant is "buyer". This structure avoids issues and risks for both the lead and participant. If, for example, the participation is classified as a loan, the participating lender could be viewed as an unsecured creditor unless it independently secures its position in the collateral, which is rarely the case. The buyer/seller relationship should be clearly delineated in the participation agreement.

Obligations of Lead Bank

The participation agreement should also clearly identify the obligations of the lead bank, irrespective of its percentage ownership in the underlying transaction. Typically, the lead lender is responsible for collecting payments from the borrower and remitting to the participant(s) some proportionate share. The timing, as well as calculation and distribution of payments, must be identified with specificity in the agreement.

The lead lender generally also has obligations to notify its participant(s) for material changes in such items as the borrower's financial condition, and the value and/or lien status of the loan's collateral. The occurrence of an event of default and the borrower's request for changes to the terms of the loan are frequently triggers for notice, as well.

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About the Firm

In 2011 Shapiro Sher Guinot & Sandler was named the top medium-size law firm in Maryland for "Business & Transactions" by Super Lawyers, a division of Thomson Reuters. The firm represents clients in numerous practice areas, including banking, bankruptcy, corporate, real estate, tax, and commercial litigation.

The firm's banking lawyers provide experienced counsel in connection with all aspects of commercial loans. Co-chaired by **K. Lee Riley, Jr.** and **Scott W. Foley**, the firm's **Banking & Financial Services Group** represents regional and community banks, credit unions, finance companies, pension funds, and other financial institutions in Maryland and throughout the Mid Atlantic.

Mr. Riley advises financial institutions in commercial lending transactions; Mr. Foley advocates for financial institutions in commercial loan workouts, restructurings, and bankruptcy proceedings. Because the group has extensive experience in the origination of loans and in workout situations, it is prepared to provide efficient representation at every stage in the commercial lending process. With over thirty years of experience in the banking industry between them, Mr. Riley and Mr. Foley appreciate the potential hazards facing clients in the commercial loan process, and strive to protect lenders' interests throughout the lifecycle of the loan.

For more information about the Banking & Financial Services Group, contact Mr. Riley at LRiley@ShapiroSher.com or Mr. Foley at SWF@ShapiroSher.com.

In general, the lead lender has a duty to exercise the same business judgment and care in the administration of the loan as if it were the sole lender in the transaction. Notwithstanding this duty of care, the participation agreement should dictate which decisions regarding administration of the loan—particularly in the event of borrower noncompliance—are to be handled exclusively by the lead, versus which decisions must include the input of the participant(s).

Intercreditor Issues

As mentioned above, absent a clearly drafted participation agreement, issues regarding the handling of a participated loan that becomes "troubled" can create conflicts among the lenders. Drafters have dealt with these anticipated conflicts in a number of ways, ranging from providing the lead lender the exclusive right to make enforcement decisions, to requiring unanimity among all of the lenders as to any decision related to remedies under the loan documents. While some form of "majority rules" would appear on its face to be the fairest method of handling work-out matters, this process has potential for causing delays and deadlocks at a time when swift decision-making is imperative. On the other hand, allowing the lead lender to make all decisions, even if that party only happens to hold a small interest in the loan, may also create tension.

Critical to the drafting of the subordination agreement is clear language with respect to the handling of defaulted loans. These provisions should identify with specificity such items as when a participant is entitled to receive notice, and at what point the participant is entitled to participate in the decisions relating to the course of action to be taken on behalf of the lender group. A well drafted loan participation agreement will not only set forth the terms of the transaction, but will reflect the goals and expectations of the parties for all anticipated events.

Riley Testifies in Favor of UCC Amendments

Lee Riley, Chair of the UCC Subcommittee of the Business Law Section of the Maryland State Bar Association, testified on February 21 in Annapolis before the Economic Matters Committee in favor of certain changes being proposed by the Uniform Law Commission. House Bills 700 and 713, which have since passed, proposed revisions to Articles 1 and 9 of the UCC, respectively, which are designed, according to Riley's testimony, "to conform to modern business practices and technological developments that have arisen over the past several years." He added that "as our commerce has become more global, it is increasingly essential that commercial law be uniform, which may be achieved through the coordinated cooperation of the states and jurisdictions. Accordingly, it is important for Maryland to complete the updates of the UCC to maintain and preserve the role of state law in commercial transactions."

Proposals to Article 1 of the UCC, which provide definitions and general provisions governing the entire Code, improve harmonization of the Article with the other revised articles, as well as the need to reflect in Article 1 recent changes and developments in the law. While many of these changes are of a technical, non-substantive manner, certain revisions are aimed to impact the scope and applicability of the Article. Importantly, these clarifications reduce interpretation problems that may generate unnecessary litigation.

Perhaps most significant to the commercial banking community are the proposed modifications to Article 9, which govern secured transactions in personal property. The current amendments provide greater guidance in a number of areas, including:

- the appropriate name of an individual debtor to be provided on a financing statement;
- more detailed guidance for the debtor's name on a financing statement when the debtor is a corporation, limited liability company or limited partnership, or when the collateral is held in a statutory or common law trust or in a decedent's estate; and
- greater protection for an existing secured party having a security interest in after-acquired property when its debtor relocates to another jurisdiction or merges with another entity.

For further information about the UCC legislation, contact Mr. Riley at LRiley@ShapiroSher.com.