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Lessons Learned in Recent Participation Agreement Litigation

Jennifer Burch Dempsey and William V. Custer*

This article outlines a few of the lessons and tips to be learned from recent participation agreement litigation and suggests improvements to participation agreements that can be employed before we find ourselves in the next economic downturn.

Banks have increasingly used participation agreements over the last several decades to pool loans among multiple lenders—with an originating or lead bank selling a portion of the loan to one or more banks as loan participants. Loan participations can inure to the benefit of both the lead and participating bank, allowing the banks to pool their resources. Through loan participations, lead banks obtain the opportunity to make larger loans to their customers without the obligation to carry the entire asset on their books, and participant banks obtain the ability to participate in larger loans or in different markets than would otherwise be available to them.

To facilitate a loan participation, the lead and participating banks typically enter into a written participation agreement to govern the relationship and the obligations owed to each other with respect to the loan. While often derived from bank forms that have been widely circulated and revised on an *ad hoc* basis over years, participation agreements can differ significantly in their terms and requirements. These terms are far from boilerplate and can have a critical impact upon the rights of the parties when there is a dispute over the administration of the loan or the collateral.

During the recent economic recession, disputes between originating and participating banks over loan participations have become all too common. These disputes have arisen most frequently because the banks involved find that when the loan is downgraded or the borrower defaults, the banks discover that they have differing interests in the handling of the loan. Some originating banks have a greater interest in working with the borrower in such situations than their participants. Some participant banks have a greater interest in pursuing an

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aggressive collection of the loan than their originating banks and sometimes vice versa. No situation is identical. Unfortunately, when the banks involved in such disputes have turned to their participation agreements for guidance, only then have they discovered that the time-worn forms that they have been using for years leave much to be desired. As a result, litigation has frequently ensued.

Many of these disputes could have been easily avoided if the parties had used a clearly drafted participation agreement at the outset that adequately covered those areas that are most likely to be a source of friction during a dispute over the handling of the loan. Because of the recent increase in disagreements among lead and participant banks, and the resulting increase in litigation over such agreements, we now can identify many of those areas. Frankly, there is no teacher like experience. The following article will outline a few of the lessons and tips to be learned from recent litigation and suggest improvements to your participation agreements that can be employed before we find ourselves in the next economic downturn.

DISCLOSURE: WHAT NEEDS TO BE DISCLOSED, WHEN DOES IT NEED TO BE DISCLOSED, AND HOW DOES IT NEED TO BE DISCLOSED?

A common provision in most participation agreements requires the lead bank to disclose certain information regarding the loan to the participant bank either upon the occurrence of certain events or upon request of the participant bank. For example, the lead bank may be required under the terms of the participation agreement to disclose when a borrower goes into default, when a loan is downgraded, or to provide prompt notice of any other potential problems with the loan. There may be specific requirements in the participation agreement about when or how that information must be disclosed.

A dispute related to the disclosure obligations of lead banks was addressed thoroughly by the United States District Court for the Middle District of Georgia in a case where a participant bank argued that the lead bank did not comply with its disclosure obligations.[1] The lead bank in that case did not timely disclose to the participant bank its decision to internally downgrade the loan's risk rating. Pursuant to the participation agreement that governed the parties' relationship, the lead bank was obligated to provide the participant bank with prompt written notice in the event that it "materially downgrade[d] its relationship with a borrower." Additionally the participation agreement

[1] *Sun American Bank v. Fairfield Financial Services, Inc.*, 690 F.Supp.2d 1342 (M.D. Ga. 2010).

required the lead bank to inform the participant bank of any circumstances which "could have a material, adverse affect [*sic*] on the Loan or the value of the collateral securing the Loan." The court noted that the particular participation agreement at issue encouraged openness and full disclosure between the parties and that "[t]he purpose of the disclosure requirements is to give the Participating Banks a full opportunity to make informed decisions about the administration of the loan and to manage its own risks. [The lead bank's] failure to disclose made it the sole master of the risk. . . ."[2] The court held that the lead bank's failure to disclose promptly the decision to internally downgrade the loan was a breach of both of these obligations that the lead bank owed the participant bank under the participation agreement.

Lessons Learned in Litigation Regarding Disclosure Obligations

- When drafting and negotiating a participation agreement, participant banks need to consider the practicalities of what they will need and want to know.
- Lead banks need to consider the scope of information they are agreeing to provide, and the reasonableness of the method and timing for disclosure.
- When operating under a participation agreement, lead banks should take special care to provide participants with the disclosures that the participation agreements require, and keep clear and detailed records of what disclosures were provided and when.
- In addition to providing the information and documents required by the participation agreements, some lead banks take the step of providing periodic memos or conference calls in which they routinely update participants on the status of the loan and invite questions or feedback, in order to meet fully their disclosure obligations.

CONSULTATION/CONSENT: WHEN IS CONSULTATION WITH THE PARTICIPANT BANK NECESSARY? WHEN IS CONSENT OF THE PARTICIPANT BANK NECESSARY?

The lead bank's duty to disclose under a participation agreement may also include an added duty to consult with the participant bank, and perhaps even a duty to obtain a participant's consent prior to taking certain actions. Common actions that may require consultation or consent include: the extension of a maturity date, the reduction in the principal of the loan,

[2] *Id.* at 1367.

reduction in the interest rate on the loan, and the release of guarantors or collateral. The items requiring consultation and consent and the manner in which consultation must occur or consent obtained should be specified clearly in the participation agreement. Some older participation agreements in use can be so specific that they still require consent in writing to be received by the lead bank by "telex." Others allow verbal consent, but only if later confirmed in writing, may permit verbal consent alone, or may not specify the type of consent required at all. Disputes can arise when lead banks do not consult with the participants when required, participants believe they should have been consulted more, lead banks act without obtaining the required consent, or participant banks unreasonably refuse to give consent.

A dispute related to consultation and consent was addressed in a recent case before the United States District Court for the Northern District of Illinois. In that case, the participation agreement required the lead bank to seek prior written consent from the participant before changing the maturity date or interest rate on the loan.[3] After the participant bank suggested that the lead bank commence foreclosure proceedings, the lead bank, without the consent of the participant bank, instead negotiated an extension of the loan and a lower interest rate with the borrower. The lead bank argued that it was absolved from having to seek consent based upon a provision of the participation agreement that stated: "[i]f the parties are unable to reach an agreement on a mutually agreeable course of action, [the Lead Bank] may thereafter foreclose the Mortgage *and* take such other actions in [the Lead Bank's] judgment are appropriate."[4] The court held that the lead bank had breached the participation agreement, and held that the lead bank only had unfettered power to restructure the loan when it had actually foreclosed on the property. Prior to foreclosure, consent by the participant bank was required.

Similarly, the United States District Court for the Middle District of Florida held in another case that when the lead bank failed to notify the participant bank of a material downgrade in the loan, waived the release price on the loan, and improperly funded loan advances, it breached the participation agreement, which required the participant bank's consent to those matters.[5]

Lessons Learned in Litigation Regarding Consultation or Consent

- When drafting and negotiating a participation agreement, banks need

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[3] *U.S. Bank Nat'l Assn. v. Builder's Bank* (N.D. Ill. 2011).

[4] *Id.* (emphasis added).

[5] *PNC Bank Nat'l. Ass'n v. Branch Banking and Trust Co.* (M.D. Fla. 2010), *rev'd in part on other grounds*, 466 Fed.Appx. 766 (11th Cir. 2011).

to consider their level of comfort with the lead bank making administrative decisions. Lead and participating banks which have comfort and familiarity with each other may be inclined to limit the amount of consultation or consent that is necessary.

- The possibility exists, however, that the lead or participant may be replaced at some point if they are taken into receivership by the FDIC or acquired by another bank. In such circumstances an unknown and unfamiliar bank or non-bank may take over the lead or participant position. In view of this possibility, the participant bank may well wish to retain the option to limit the ability of the lead bank to act without its consent or its right to change the lead bank altogether. Similarly, the lead bank should consider that the cooperative participant bank with whom it is now dealing may be a stranger with completely different goals in the future.
- When operating under an existing participation agreement with disclosure obligations, lead and participant banks should pay close attention to the types of issues that require consultation or consent. The obligation to consult may be met by having regular conference calls or meetings to address developments in the loan.

DOCUMENTATION: WHAT DOCUMENTS NEED TO BE MAINTAINED BY THE LEAD BANK AND PRODUCED?

Participation agreements often include an obligation on the part of the lead bank to hold documents related to the loan or collateral, and produce such documents to the participant bank upon request. Many lead banks provide certain key documents to their participants through web-based systems that are maintained by the bank or other managers of the property. The scope of documents that the lead bank may be obligated to maintain and produce, however, may be quite a bit larger than just the loan documents themselves, and may well extend to any document related to the loan including internal emails and memoranda.

Lessons Learned in Litigation Regarding Maintaining and Producing Documents

- When drafting and negotiating a participation agreement, lead and participant banks will need to consider carefully what documents should be included in the lead bank's obligation to maintain documents and produce documents.
- The time frame for production upon the participant bank's request and the method for production may also need to be considered.
- For banks that are already in participation arrangements that may not

be going well, it is often very effective when evaluating the viability of a participant bank's claims against a lead bank for the participant to request documents pursuant to one of these document clauses. A review of those documents can bring a better understanding of whether a lead bank has met its various obligations under the participation agreement.

ADMINISTRATION STANDARDS: WHAT STANDARDS SHOULD GOVERN THE ADMINISTRATION AND REPAYMENT OF A LOAN PARTICIPATION?

Participation agreements invariably impose the obligation of administering the loan upon the lead bank, with varying degrees of specificity regarding what "administration of the loan" involves. The precise contours of this obligation by the lead bank are highly important because, when disputes arise, the duties of the lead bank may determine the remedies available to the participant banks.

It is common in participation agreements to simply require that the lead bank "administer, hold and collect on the loan with the care of a prudent man under the circumstances." Other participation agreements are more specific regarding the mechanics of loan administration, requiring specific details for each task to be performed. For example, many agreements require that amounts collected by the lead bank be dispersed to the participant bank within a particular time frame, or in a particular manner. Whether the proceeds are to be disbursed on a first out, last out, or pro rata basis and whether such disbursements are to change following a default by the borrower can have a dramatic impact on the economic positions of the parties.

Such details, while seemingly innocuous on the front end of the relationship, can have enormous significance when disputes arise. A number of different cases have arisen in recent years over the appropriate disbursement of loan proceeds following the borrower's default. Additionally, disputes have arisen where the participant bank believes a lead bank is not pursuing collections from a borrower or guarantor with sufficient diligence or, conversely, that a lead bank is not doing enough to work with a borrower when the borrower is technically in violation of the loan documents. Similarly, a lead bank may become frustrated with a participant bank who is unreasonably refusing to give consent to an action when such consent is required to fully pursue the borrower or, on the other hand, to grant the borrower an accommodation.

A dispute regarding when and how disbursements were required to be paid was recently addressed in a matter before the United States Court for the Middle District of Florida. The participation agreement there required the lead bank to pay disbursements to the participant bank on a "LIFO" basis.[6] The lead bank mistakenly paid disbursements on a "pro rata" basis, rather than a LIFO basis, for nearly a year before it realized its mistake. The lead bank notified the participant bank of the error, proposed a way to remedy the error by email, the participant bank agreed to the proposal in an email, and the lead bank then paid the participant bank the difference between what it had disbursed and what it should have disbursed. The participant bank subsequently filed a claim for breach of contract, however, and the court determined that the email exchange constituted a waiver of the right to sue for breach of contract.

An additional claim that banks may assert in such litigation is that the lead bank failed to properly conduct due diligence on the borrower or guarantors.[7] Often participation agreements have specific language precluding such a claim and requiring participant banks to exercise their own judgment in the analysis of the borrower and the borrower's creditworthiness. Some participation agreements go even further to provide that the participant bank agrees that it has independently verified the credit evaluation performed by the lead bank.

Lessons Learned in Litigation Regarding Administration Standards

- When drafting and negotiating a participation agreement, lead and participating banks may want to consider that the disputes that arise related to administration of the loan often concern the method a participant bank will be paid disbursements, or the method in which the participant bank must pay advances to the lead bank.
- Banks need to consider the method that a participant bank must pay its advances. For example, a participant may be required to pay advances
    - (1) in a single disbursement after advances are completed;
    - (2) on a "first in" basis (participant to fund the first advances until the participant's amount is exhausted);
    - (3) on a "last in" basis (those other than the participant will fund advances until their amount is exhausted, then the participant will pay advances);
    - (4) on a "pro rata" basis (a continuing agreement where the lead and participant pay advances according to the respective percentage they have in the loan); or
    - (5) some other clearly defined basis.

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[6] *PNC Bank v. Branch Banking and Trust Co.*, 704 F.Supp. 2d 1229 (M.D. Fla. 2010).

[7] *Cleveland Motor Cars v. Bank of America*, 295 Ga.App. 100 (2008) (asserting such a claim after the sale of loans).

- Banks need to consider the method that a lead bank shall make disbursements to the participant bank. For example, a lead bank may be required to:
  - (1) make disbursements on a "first out" basis (until the participant receives an amount equal to its participation amount, and then to the lead bank);
  - (2) a "last out" basis (until the lead bank has received an amount equal to its loan interest, and then to the participant bank);
  - (3) a "pro rata" basis (ratably between the participant bank and lead bank, based upon the participant bank's share); or
  - (4) some other clearly defined basis.
- Lead banks should include a provision stating that the participant banks have independently verified credit information regarding the borrower and guarantor, and did not rely upon the lead bank's evaluation of the credit.

CIVIL LIABILITY: WHAT TORT LIABILITY EXISTS BEYOND CONTRACTUAL DUTIES?

In many recent disputes involving participation agreements, the aggrieved party includes a claim that the lead bank breached its fiduciary duty. This is a highly litigated issue that can easily be avoided with careful drafting. Fiduciary duties are not to be inferred without explicit language in the participation agreement establishing such duties and setting the scope of those duties.[8] Courts do not infer such fiduciary duties to exist without such language because participation agreements are commercial transactions between sophisticated

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[8] *PNC Bank Nat'l. Ass'n v. Branch Banking and Trust Co.*, (M.D. Fla. 2010), *rev'd in part on other grounds*, 466 Fed.Appx. 766 (11th Cir. 2011); First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A., 919 F.2d 510, 514 (9th Cir. 1990); *Banque Arabe et Internationale D'Investissement v. Maryland Nat. Bank*, 57 F.3d 146, 158 (2nd Cir. 1995) ("Generally, banking relationships are not viewed as special relationships giving rise to a heightened duty of care. In the case of arm's length negotiations or transactions between sophisticated financial institutions, no extra-contractual duty of disclosure exists. This same principle applies to loan participation agreements, in which there is deemed to be no fiduciary relationship unless expressly and unequivocally created by contract."); *Washington Fed. v. Countrywide Home Loans, Inc.* (W.D. Wash. May 23, 2013) ("[i]t is appropriate to look to the terms of the Agreement because unlike the automatic, status-based fiduciary duty which exists, for example, between attorney and client, fiduciary duties among loan participants depend upon the terms of their contract.").

financial institutions and are typically arm's length transactions.[9]

Claims for other torts in disputes related to participation agreements is an area that has been litigated as well. In general, however, courts hold that to bring a tort claim, the duty owed to the plaintiff must be independent of duties set forth in a contract.[10]

Lessons Learned in Litigation Regarding Tort Liability

- Lead and participant banks should carefully draft exculpation clauses and explicitly state whether tort liability is created or excluded for actions related to the participation agreement.
- If the parties do not intend to create a fiduciary relationship, they should specify that there is no fiduciary relationship between them.

BREACH: WHAT ARE THE CONSEQUENCES FOR BREACHING A PARTICIPATION AGREEMENT?

Damages related to breaches of participation agreements can be difficult to calculate in certain situations. The question that judges and juries are frequently required to ask is "but for the breach, would the party have been damaged and by how much?" Proving such damages may be difficult when the breach, for instance, is simply a failure to provide information or a failure to appraise the collateral. In such cases, it is difficult to establish what actions would have occurred, when, and to what result if the breach had not occurred. To alleviate the problem created by the uncertainty of proving damages for breach of a participation agreement, many agreements contain a "buy-back" or "repurchase" provision which requires the lead bank to repurchase the participant bank's share in the loan upon the lead bank's material breach of the participation agreement. Conversely, the participation agreement may require the participant bank to purchase the lead bank's share in the loan upon the participant bank's material breach of the participation agreement.

Such clauses have been upheld as "enforceable as a reasonable method for restoring the parties to their original position in a situation where a breach

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[9] *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, 919 F.2d 510 (9th Cir. 1990).

[10] *Delancy v. St. Paul Fire & Marine Ins. Co.,* 947 F.2d 1536, 1545 (11th Cir. 1991) ("a plaintiff may not sue in tort for a defendant's mere breach of a duty imposed by a contract."); *Morrison v. Exxonmobil Corp.*, 1:03-CV-140 (WLS) (M.D. Ga. Sept. 28, 2005) (the "mere breach of contract does not support a claim of fraud.").

cannot be cured and actual damages can be very difficult to calculate."[11] In analyzing the enforceability of repurchase clauses, several courts have addressed the question of whether a repurchase clause constitutes a specific performance remedy or whether it is a liquidated damages clause.[12] The United States Court for the Middle District of Georgia ultimately concluded that it did not matter whether a repurchase clause was a liquidated damages provision or a specific performance remedy—it was still enforceable.[13]

Lessons Learned in Litigation Regarding Proving Damages

- When negotiating or drafting a participation agreement, lead and participant banks may wish to carefully consider whether the damages and remedies available are specifically included in the participation agreement. Banks should consider including a buy-back or repurchase clause as a remedy for breach of the agreement.

RECEIVERSHIPS: WHAT CAN BE DONE TO PROTECT YOUR BANK IF THE LEAD BANK GOES INTO RECEIVERSHIP?

Many participation agreements contain clauses that require consent prior to assignment or sale of the lead or participant bank's interest in the participation. Complications can arise, however, when the lead bank is placed into receivership with the FDIC, the FDIC subsequently sells the lead bank's interest in the participation to an entity that may not even be a bank, and that entity then takes the position that banking regulations and practices do not apply to it. Numerous community banks have found themselves in just such a position during the last recession.

Lessons Learned in Litigation Regarding Future Assignments

- One way to address this issue is to include a clause providing that the

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[11] *Sun American Bank v. Fairfield Financial Services, Inc.*, 690 F.Supp.2d 1342, 1365–1366 (M.D.Ga. 2010).

[12] *LaSalle Bank Nat'l Assn. v. Capco Am. Securitization Corp.*, (S.D.N.Y., Nov. 14, 2005) (repurchase clause "provides for liquidated damages in the event that a breach cannot be cured."); *Greyhound Fin. Corp. v. TSM Fin. Group,* No. 92 C 3750 (N.D.Ill., Aug. 5, 1993) (repurchase clause amounts primarily to monetary compensation, but "the Court would also have to order Defendant to take possession of the defaulted loans or deduct some amount to reflect the value of the loans.").

[13] *Sun American Bank v. Fairfield Financial Services, Inc.*, 690 F.Supp.2d 1342, 1365–1366 (M.D.Ga. 2010) ("[The repurchase clause] is similar to a liquidated damages provision, in that it requires the repayment of a quantifiable and specified amount of money. [The repurchase clause] is similar to a specific performance remedy, in that it requires [the lead bank] to take back possession of the Participation Interest.").

participation agreement is a personal services contract, premised upon the participant's trust and confidence in the lead bank to administer the loan, and to further provide that the right to administer and service the loan is not assignable.

- The participation agreement could include an *ipso facto* clause "that provides the consequences if a certain event occurs."[14] This *ipso facto* clause should state that upon the occurrence of a qualifying event—like the insolvency of the lead bank—the participating bank can assume the administration of the loan.[15] Whether such a provision can be successful in the face of the FDIC superpowers is an issue that remains in some dispute.[16]

CONCLUSION

When drafting participation agreements, lead and participation banks must negotiate the painful details of each participation agreement and pay close attention to the specific duties and obligations of each party. If the recent recession has taught banks anything about these agreements, it is that the parties should always anticipate the loan will go into default and carefully draft their agreements with a particular focus upon what will happen after a default. It is at that point where the vast majority of these disputes arise. The precise language of the agreement will determine the parties' respective fate in such circumstances. It is dangerous to simply rely upon the historic relationships that might have existed between the lead and participant banks and take it for granted that the parties will always "work it out." The parties should fully anticipate that the party with whom they contracted at the outset of the loan may well not be the same party with whom they must deal when the loan ultimately goes into default. In that event, one should assume that only the terms of the contract will protect them from a party that does not share their interests. Finally, the parties should consider that the available remedies and claims following a dispute will also likely turn on the specific terms of the participation agreement.

If banks could simply address the few issues that have been presented in this

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[14] *CRE Venture 2011-1, LLC v. First Citizens Bank of Georgia*, 326 Ga.App. 133, 756 S.E.2d 225 (2014).

[15] *Id.*

[16] *Devonshire Park, LLC v. F.D.I.C.* (M.D. Fla. July 23, 2010) (holding that FIRREA prohibits a party in a contractual relationship with an insolvent bank from invoking an *ipso facto* clause contained in the contract against the FDIC).

article at the beginning of every loan participation, they could potentially avoid the vast majority of disputes that have ended in litigation between banks during the last recession.