LOAN PARTICIPATIONS – TIME FOR ANOTHER LOOK
Part I

By Andrew Connor

A loan participation is an arrangement between lenders in which one lender ("Lender A", also known as the "lead") makes a loan to a borrower and separately, then or later, sells an interest in the loan to another lender ("Lender B" or the "participant"). Sometimes, there are multiple sales to different participants. In most cases, Lender A retains an interest in the loan, but it is not unknown for the lead to sell participations totaling 100% of the loan. Lender A holds all the loan documentation in its own name, is the secured party with respect to any collateral, is the beneficiary of any guarantee(s), and services the loan, acting as the lender which deals with the borrower.

The use of participations has benefits to both originators of loans and to the purchasers of the participations. In many instances, Lender B buys the participation as a way to make a loan which it otherwise could not make. Lender A sells the participation because it wishes to lessen its exposure. And, because banks are subject to loan limits imposed by law (as well as internally imposed limits), if a borrower wants a larger loan than a bank is allowed or willing to make, the bank may need to sell a participation in order to make the loan.[1] At the same time, the participant gets to diversify its loan portfolio and to obtain business it would not otherwise get.

Participations are different from situations where A and B each make a loan to the borrower independently. They are also different from "club" loan facilities and syndicated facilities, where two or more lenders acting together agree to extend credit to a borrower and one of the lenders is named agent for all lenders, administering the loan and acting as secured party on behalf for all if there is collateral. In either of these instances, each lender has a direct contractual relationship with the borrower. With a participation the participant does not: the loan documentation is only between the lead and the borrower. Indeed, the borrower may not even know that there is a participant, which is sometimes how Lender A wants things in order to keep Lender B away from the borrower. Lender A controls the customer relationship, the terms of the loan, and the administration of the loan. As between the lead and the borrower, that is simpler and more convenient. Adding additional lenders to the relationship adds complexity – questions about administration and about what voting rights the lenders have among themselves with respect to approving amendments, modifications, and waivers. In a participation, whatever agreements may be made between Lender A and Lender B with respect to loan administration are usually not part of the borrower's deal with Lender A.

The document setting forth the participation between Lender A and Lender B is typically called a participation agreement. It can be lengthy or short and as creative as the parties choose to make it to define the interest which A is selling and B is buying. Lender B's participation interest may be based on a straight percentage of the loan or it may be more complicated, such as based on the concept of last-in, first-out for the participant. If the credit facility includes both a term loan and a revolving loan, Lender B may only participate in one loan, rather than both. It is also not unknown for the participant to receive interest at a different rate than is applicable to the underlying loan. The arrangement between Lender A and Lender B may allocate specific collateral or even subordinate one loan to the other. Thus, if there is a revolving credit facility based on accounts and inventory (although secured by additional collateral) and a term loan (secured by the same collateral), the participation agreement may provide that in a default scenario all proceeds of accounts and inventory are applied first to pay down the revolving line. The agreement may also include a right on the part of Lender A to repurchase the participation or give Lender B the right to purchase the entire loan from Lender A in certain circumstances.

Recently, we had occasion to review a participation agreement for an unhappy participant. The subject loan, a term loan, had originally been made by the lead and then our client bought a participation. A year or so later, the loan became due but was not paid and was in default. The lead had just notified our client that the lead was going to sell the loan to a third party at a discount. Our client had then reviewed the participation agreement (which was signed without our involvement), was perturbed by what it said, and asked for our advice.

The participation agreement itself was slightly over six pages in length. It described the participation as an undivided interest in the loan made by the lead to the borrower, and said that the sale of the participation constituted an assignment, without recourse to the lead, of an undivided interest in the lead's right, title and interest in and to the loan, loan documents and any collateral security the same. It also did not prohibit the lead to sell all of its remaining interest (including assigning the collateral security rights) without bothering to require that the purchaser assume the participation agreement. Conceivably, if the lead sold the loan without having the buyer assume the participation agreement, our client would be left with a right to receive payments from the old lead, but not the new one.

Moreover, our client had spoken to the lead about the situation and learned that the lead had not told the prospective buyer

about the participation. Apparently, the lead thought that the buyer would not be willing to assume the participation agreement and such disclosure might kill the deal. Quite possibly the buyer was purchasing the note with the expectation that it would be entitled to keep 100% of any collections.

So the client wanted to know what were its rights. Could it prevent the sale or require the new lead to honor the participation? And, assuming that the new lead did assume the participation agreement, could our client force any action by the lead with respect to trying to collect the debt?

We thought of several theories that might apply. The participation agreement did *sell and assign* to our client an undivided interest in the loan, the loan documents and the collateral. It seemed possible that our client insist upon institution of foreclosure and collection proceedings. Didn't the lead have a responsibility to try to collect the loan? We set out to explore these possibilities.
The participation agreement did contain some troubling provisions limiting or disclaiming duties on the part of the lead, but loan participations have been around for decades, so we expected to find that courts had established some basic principles applicable to loan participations which would afford protection to participants. By analogy, Article 2 of the Uniform Commercial Code permits a seller of goods to disclaim implied warranties, but if an express warranty fails of its essential purpose, then a disclaimer of the implied warranty of merchantability is not effective. We thought there might be cases establishing basic rights of loan participants – perhaps something akin to "good faith and fair dealing" being implied into every loan participation.

Alas, our research did not lead to such clarity. The courts have said various and inconsistent things about what duties a lead has to its participant, and have taken some unexpected (to us, anyway) positions about the nature of the participant's interest. Participants have been disappointed somewhat more frequently than we expected, often because of unanticipated circumstances and unclear drafting. This article reviews what we found and what that meant to our client. We end by making some suggestions for achieving greater clarity and certainty in such future transactions, for the benefit of all concerned, we hope.

Duties of the Lead

Given that a participant has no direct relationship with the borrower and therefore no direct means of insisting that the loan be performed in accordance with the loan documents, we thought that courts probably had implied a duty on the lead to protect the participant's interest. But how strict would that duty be?

We found that where the participation instrument is silent about loan administration, courts have held that the originating lender exercises sole control over the collection and enforcement of the loan, but the courts have recognized a duty of the lead to exercise reasonable care in these activities. For example, in *Carondelet S.&L. Ass'n v. Citizens S.&L.*[2], the court stated that the lead (Citizens) had a duty "to exercise the care and prudence which ordinary men would exercise under like circumstances in dealing with their own affairs."

Carondelet involved a real estate loan by Citizens Savings & Loan Association to finance construction of a dormitory at Southern Illinois University. Carondelet Savings and Loan Association and another lender, Bohemian Savings & Loan Association, purchased participations in the loan from Citizens in 1965. The loan performed until late in 1969, when student housing demand dropped. Over the next three years, Citizens made several efforts to salvage the situation, with Bohemian's support but over objections by Carondelet. Citizen's efforts included modifying the payment schedule, reducing monthly payments for a time, and allowing the loan to go without payment for 8 months during 1972, before Citizens finally decided to foreclose. Carondelet sued, seeking money damages or rescission, alleging that Citizens' actions constituted breach of contract or breach of fiduciary duties. The trial court ruled that the participation agreement did not require immediate foreclosure upon default and gave Citizens "the exclusive right to decide how to service" the loan and was only obligated to foreclose after exercising reasonable efforts to collect the loan. So, there was no breach of contract. The court emphasized that the participation agreement granted a great deal of discretion to Citizens and that Citizens' forbearance and other efforts to salvage the loan were reasonable exercises of that discretion.

In *Carondelet,* the court said that Citizens was a fiduciary for its participants, but found no breach of duty. Accordingly, we thought that we might find that courts have implied fiduciary duties on the lead. But in the other cases that had considered the issue, courts had generally declined to find that a fiduciary relationship exists unless the terms of the participation agreement could be read to create it. For example, in *First Citizens Federal Savings & Loan Ass'n v. Worthen Bank & Trust Co.*,[3] the Ninth Circuit Court of Appeals said that a fiduciary relationship "should not be inferred absent unequivocal contractual language."

A case where such language was present is *Women's Federal Savings & Loan v. Nevada National Bank*[4], and as a result the court found a fiduciary relationship and that the lead had failed to meet its duties. Here's the story: Women's Federal Savings & Loan ("WOFED") was located in Ohio, but had a relationship of some sort (not explained) with John and Barbara Cavanaugh. The Cavanaughs acquired a casino-motel in Reno, Nevada called the Gold Dust West ("GDW"). They contacted WOFED about financing some improvements to GDW, and WOFED was interested but insisted that a local Nevada bank participate as co-lender and agree to administer the loan. Mr. Cavanaugh contacted Nevada National Bank ("NNB"), and it agreed to fill that role.

WOFED and NNB entered into a participation agreement, and WOFED purchased a 90% interest in the loan of $2.8 million which NNB made to the Cavanaughs in July 1977. The loan was secured by a first deed of trust in favor of NNB on the GDW real estate, which deed of trust contained a prohibition against creating any junior liens without the consent of the beneficiary. WOFED was not a beneficiary of the first deed of trust or a secured party in any other way vis-à-vis the borrower.

The terms of the participation agreement called for NNB to "act as a trustee with fiduciary duties" in administering and servicing the loan. In addition, the agreement specifically required NNB to monitor and to periodically investigate the financial condition of the Cavanaughs and GDW, and to inform WOFED promptly of any development that threatened the security of its investment, and required that NNB establish an impound account for real estate taxes and insurance premiums, and a custodial account for amounts due to WOFED.

Subsequently, GDW had financial trouble, and in January 1978, NNB loaned the Cavanaughs an additional $1.5 million secured by a second deed of trust on the GDW property, without informing or obtaining consent from WOFED. In June 1980, NNB advanced a further $750,000 under the second deed of trust, again without informing or obtaining consent from WOFED. The interest rates on these two loans were higher than the rate applicable to the loan in which WOFED was a participant, such that the Cavanaughs' monthly payment to NNB eventually was almost three times the monthly payment amount to WOFED.

In September 1982, the Cavanaughs became three months delinquent on the WOFED-NNB loan, which was their first serious delinquency on that loan. WOFED contacted NNB concerning this delinquency and learned, for the first time, that the Cavanaughs and GDW had been having difficulties. WOFED also learned that NNB had extended additional loans to the Cavanaughs and taken the second deed of trust and that NNB had failed to establish the required segregated impound and custodial accounts. WOFED directed NNB to file a notice of default on the first deed of trust, but this became moot as the Cavanaughs were able to cure the default within the statutory period and subsequently stayed current on the loan.

Notwithstanding that WOFED had received all payments due to it, it filed suit against NNB claiming breach of contract and breach of fiduciary duties and seeking rescission of the participation and disgorgement of NNB's profits from the second deed of trust loan. At trial, the district court found that NNB had breached its contractual and fiduciary duties to WOFED, but concluded that WOFED had failed to show that it had been damaged by those breaches. The court therefore refused to grant rescission or order any disgorgement.

On appeal, however, the Ninth Circuit Court of Appeals felt otherwise and held that rescission was appropriate, *even though WOFED had received all payments that were due on its loan,* saying that WOFED should not be compelled to stay in the relationship after its fiduciary had proven itself untrustworthy and holding that WOFED had bargained for, and was entitled to receive under its contract with NNB, something more than just sharing the risk of the loan to the Cavanaughs.

Guaranty Sav. & Loan v. Ultimate Sav. Bank is another case that found a fiduciary relationship between lead and participant, but solely based on wording in the participation agreement. Unfortunately, our client's participation agreement contained no such language. Worse, it explicitly denied that the lead was a fiduciary.

In fact, we found few cases other than *Carondelet*, taking the view that the lead had any implied fiduciary duties. In one, *First Bank of WaKeeney v. Peoples State Bank*,[5] a Kansas appeals court suggested that a fiduciary relationship "may be implied if a joint venture is found". For this, however, the court said that the participation agreement had to contain some language giving the participant explicit control over the loan. How much control, the court did not say. But our client had very little control over the loan. The participation agreement gave the lead very broad powers to amend or to modify the loan documents, to waive their terms, to waive the lead's other rights and powers, to refrain from exercising any or all of such powers, and to release collateral, all without our client's consent. Only reductions in the principal or interest rate and extensions of the stated maturity of the loan were subject to our client's approval. This was not a strong basis for claiming that there was a joint venture.

In *Royal Bank of Canada v. Interfirst Bank Fort Worth*, *N.A.*[6] the court decided that the lead, Interfirst Bank Fort Worth, and the participant, Royal Bank of Canada, had a principal-agent relationship, but that was not enough to establish a fiduciary duty on the part of the lead.

There, Royal Bank tried to emphasize that the participation gave rise to fiduciary duties because it provided that Interfirst would exercise the same care in respect of the loan as it used in the making and the handling of its own loans – wording similar to the implied duty of the lead characterized as "fiduciary duty," according to *Carondelet*. In support, Royal Bank pointed to the "blind" nature of the participation (under which Royal Bank was not to have any contact with the borrower), subjecting RBC to a greater level of dependency, as a basis for imposing a higher duty on Interfirst as the lead. But the court rejected that view and said that "ordinarily, banks involved in commercial arms-length transactions do not stand in a fiduciary relationship with each other," and that "the normal degree of trust between a lead bank and a participatory bank is not enough alone to give rise to a fiduciary relationship."

Women's Federal illustrates the perils that come with being a fiduciary and it is not surprising that lead lenders would seek to avoid such duties. But, even if the lead is not a fiduciary, as an agent it must have some duties and, as noted, some courts have said that the lead is obligated to exercise reasonable care in handling the loan.

But what is reasonable care, and when does it have to be exercised? Does the lead have this duty only with respect to its actions after the participation is actually sold? Or does it apply to the entire relationship, including the lead's actions before the participant invests? Is the participant entitled to a presumption that the lead exercised reasonable care in making the loan? Possibly, we thought, our lead might have failed to exercise appropriate care in making the loan. If so, there might be a basis to seek a remedy. So, we asked our client if it had queried the lead for the underwriting information, the basis for the loan, before deciding to purchase the participation.

"Yes," they said, they had. And did they rely on that, we asked? "Sure," the client answered. "The lead gave us lots of information and verbally assured us that they thought the risk was minimal and that we'd have no problems."

The participation agreement, however, included an express statement that our client had made its own credit analysis of the borrower and the loan. It also contained a disclaimer by the lead stating that it made no representations or warranties about the borrower, the accuracy of any information provided to our client, the legality or enforceability of the loan documents, the filing of financing statements, or the financial condition of the borrower (except that the outstanding loan principal balance was as stated and that the lead owned the loan and had the power and authority to sell the participation).

In such circumstances, at least one court has held that reliance by the participant was unjustified and not actionable. In *Bank of the West v. Valley National Bank of Arizona*[7], the lead (Bank of the West) made loans to Technical Equities Corporation ("TEC"), but as the line of credit grew, Bank of the West decided that it needed a participant in order to avoid violating its lending limit. Valley National Bank became the participant, eventually committing to 50% of the loan and agreeing to bear 50% of any "Extraordinary Expenses". (Under the participation agreement, the lead was to bear the ordinary costs of managing the loans.)

TEC was primarily in the business of buying and selling residential property. In January 1985, Bank of the West discovered that TEC had in some cases bought a property and then re-sold it at a higher price with 100% financing, carrying the value on its books at the higher re-sale price. The case did not say whether Bank of the West's failure to learn this was due to sloppy underwriting, but whatever the reason, Bank of the West immediately notified Valley National Bank by telephone and the banks made no further loans to TEC after that. At this point, the total debt of TEC to the banks was about $10.3 million, of which Valley National, as participant, had funded approximately $4 million.[8]

During the next three months, Bank of the West did an investigation, eventually generating two reports – one short and one much longer -- both of which were critical of TEC. Bank of the West did not share these reports with Valley National. In fact, not until September 1985, did Bank of the West inform Valley National of the seriousness of the problems, which it did by sending TEC a letter freezing the line of credit[9] and sending a copy to Valley National.

TEC filed for bankruptcy in February 1986, resulting in many disputes and much litigation. To quote the court:

"Its failure led to numerous lawsuits involving the banks. Hundreds of Technical Equities investors sued Bank of the West and others. Bank of the West sued Technical Equities accountants and underwriters. Bank of the West spent about $5 million on settlements and almost $6 million on attorneys' fees to defend against the investors' suits, and collected $5 million in settlements from Technical Equities' accountants and others, leaving it with a net expense of about $6 million."

Bank of the West then sued Valley National, seeking to recover one-half of the $6 million as "Extraordinary Expenses". Valley National denied the claim and counterclaimed for fraud, based on Bank of the West's concealment of the two reports. At trial, Bank of the West won on the "Extraordinary Expenses" claim, but Valley National won a jury verdict on its fraud counterclaim. But the trial judge then set aside the jury verdict on the fraud claim because it found that (a) Valley National was contractually obligated to make the payment which brought its share up to 50%, so that payment was not based on fraudulent concealment of the reports (or their substance); (b) *Valley National was contractually obligated to make its own independent assessment of TEC's creditworthiness, so could not have justifiably relied on Bank of the West* [emphasis supplied], especially not after receiving a copy of the September letter to TEC; and (c) Valley National's loss was caused by TEC's collapse, not any concealment by Bank of the West.

Both banks appealed. The Ninth Circuit Court of Appeals addressed the fraud claim first and held that justifiable reliance was an element necessary to establish the claim and was entirely missing because of express wording in the participation agreement requiring Valley National to make its own assessment of TEC. Valley National claimed that regardless of the contract terms, it did in fact rely on Bank of the West for important information concerning TEC, and the Court of Appeals acknowledged that -- saying "so far as the record shows, Valley National participated in the loan without much independent evaluation, largely on the basis of Bank of the West's judgment." That was not sufficient, said the court:

"Valley National's problem is that regardless of what they actually did, the banks expressly agreed to a relationship in which each would investigate independently and exercise independent judgment. . . . Valley National agreed that it 'independently and without reliance upon any representations of Lender [Bank of the West] . . . made and relied upon [its] own credit analysis and judgment. . . . That necessarily implies that, *to the extent that it did rely on Bank of the West, Valley National's reliance was not justifiable* [Emphasis added]."

So, even assuming a duty to exercise reasonable care in making the loan, that duty can be effectively undermined by the participation agreement. And, unfortunately, that is what our client had agreed to.

In our research, however, we ran across a case that offered another possibility. In *Banque Arabe et Internationale D'Investissement v. Maryland National Bank*,[10], the court acknowledged that there could be a claim for breach of a duty to disclose, if the lead knew something not known to the participant.

Banque Arabe was successor by assignment to BAII Banking Corp. ("BAII"). BAII had purchased a $10 million participation in $35 million of loans by Maryland National Bank ("MNB") to eight affiliated real estate partnerships. The loans defaulted and Banque Arabe eventually sued MNB and an affiliate alleging negligent misrepresentation and breach of a duty to disclose certain information.

The court held that under New York law negligent misrepresentation is not actionable unless there is a special relationship of some kind between the parties and that the participation did not rise to such a level, being an arm's length commercial agreement between sophisticated financial institutions. Similarly, without wording in the participation agreement to create it, the court declined to find any fiduciary relationship between the parties.

But the court did say that there could be a claim for breach of a duty to disclose in three situations, one of which is "where one party possesses superior knowledge not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge".

Perhaps, we thought, our client might have such a claim. Did the lead know something important which it failed to disclose and which was not otherwise "readily available" to our client? We explored the issue with the client, but to no avail. So far as the client knew, there was no material information withheld by the lead. The basic story was that the economic downturn had adversely affected the borrower's business, a risk that our client admitted to us it had considered and elected to ignore when it purchased the participation.

We were forced to conclude, and advise our client, that we could not make a credible argument that there was any breach of duty by the lead or that one would arise if the lead sold its interest in the loan and the collateral security.

We turned then to the question of whether the client might have some recourse against the borrower. Here, too, the caselaw was not very helpful, sometimes surprisingly so. In the second part of this article we'll visit the cases, several of which involve the demise of Penn Square Bank and its repercussions. Following that discussion, we will present the reader with a list of issues to be considered when a participation is being documented.