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Checklist for Reviewing Participation Agreements

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Lenders facing stiff competition in commercial lending often look to loan participations as a way of growing their institution. The rights and obligations of a lender participating in a loan will be determined primarily by the terms and conditions of the loan participation agreement that documents the transaction. Before agreeing to purchase a participation, the participant should carefully review the participation agreement to confirm that it affords the participant continuing rights to current information about the underlying loan, as well as continuing participation in major decision-making.

A participation agreement should serve three functions, each of which will have an impact on the participant's rights. The first function of the participation agreement is to transfer an undivided interest in an underlying loan from the seller to the participant; the second is to structure the rights and obligations of the parties to the participation; the third function of the participation agreement is to set out the terms for servicing the underlying loan by the lead lender.

The purchase and sale portion of a loan participation agreement should involve more than the essential transfer language (that is, the transfer of the financial asset that is referred to as a loan participation). The scope of the seller's representations and warranties may affect any potential recovery by the participant (should the participant suffer a loss under the participation caused by a failure of one of the seller's representations). Another issue that could impact the participant is the accounting treatment afforded the transaction. Generally both the participant and the seller of the participation intend that the purchase by the participant of an undivided interest in the loan be treated for all purposes, including accounting, as the purchase and sale of participation interest and absolute transfer of the interest (a true sale). Under accounting principles, a loan participation transaction will be treated (for accounting purposes) as a true sale only if it meets the definition of a participating interest as provided in the Accounting Standards Codification (Topic 860) and the transfer of the participation interest constitutes a full transfer of control over the participation interest as a financial asset by satisfying the requirements outlined in Topic 860. If a participation transaction does not meet the requirements of the accounting standards, then the transaction will be treated as a loan by the participant to the seller of the participation, with the loan secured by a security interest in the underlying loan.

The administration of the participation is the second function of the participation agreement and should cover authorization of the lead lender to act on behalf of the participant using a reasonable standard of care, as well

as establishing the timing for contributions of funds by the participant (for multiple-advance loans) and the timing for remittance of borrower payments by the lead lender to the participant. In reviewing the agreement that calls for multiple advances, the participant should confirm that the deadlines for contribution of funds set by the agreement are consistent with its own policy and procedures. For example, a same-day deadline for a contribution may conflict with the participants deadline for wire transfers if the notice of a need for contribution is received too late in the day to process it before its wire transfer deadline.

The third function of the participation agreement, loan servicing, is the most critical of the three. This part of the agreement will determine the amount of information that will be provided to the participant and the extent of participant involvement in major decision-making regarding the underlying loan and any lender response to a troubled loan situation. Most agreements grant the lead lender full authority to service the loan, but will carve out certain types of changes that would require the participant's consent. The most common of these are decreases in the interest rate on the loan, forgiveness of debt, release of a borrower and, not as common, modification of loan terms. If the underlying loan is a revolving line of credit, an important consent item for the participant is the renewal or extension of the maturity date, without which the participant can get trapped in the participation. Also important are the provisions that address the situation when the participant's consent is required but not given. Participants beware – many agreements provide that when the lead lender and participant cannot agree on a course of action, then the lead lender may determine the appropriate course of action (notwithstanding the participant's objection). This type of provision negates the provision that requires the participant's consent to certain actions.

Since the participation agreement is usually prepared by the seller, critical review of the participation agreement is essential in protecting the participant's interest. This can be done by a lender experienced with participations or by participant's legal counsel.

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