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LESSONS LEARNED IN RECENT PARTICIPATION AGREEMENT LITIGATION

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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 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.

Read the the rest of this article, previously published in The Banking Law Journal. Topics covered include obligations regarding disclosure, consent, and documentation, the appropriate loan administration standards and potential liabilities for breach, and the impact of FDIC receivership on loan participations.

MEET THE TEAM

Jennifer B. Dempsey

Atlanta

jennifer.dempsey@bclplaw.com
+1 404 572 6985

William V. Custer

Atlanta

bill.custer@bclplaw.com
+1 404 572 6828

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