
Haunted by the Ghost of Loan Participations Past and Present? (March 12, 2010)

Here's some advice on how to find a better future, while cleaning up the current mess

By Dave Weir and Curt Petersen, partners and co-founders of Lenders Capital Resources, LLC, Wayzata, Minn. Additional information appears at the end of this article.

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In assessing the state of the loan participation sector of banking, one is tempted to quote Will Rogers, who said, "If you find yourself in a hole, the first thing to do is stop digging!"

In this context, the idea is to get out of the hole that's developed by understanding where the hole came from, and then how the bank can best get out—that is, after it stops digging. And, since participations by definition involve multiple "diggers," you have to be ready to get everyone to "down tools" and cooperate in a solution.

The accepted, standard terms of loan participation agreements, and the increasing incidence of financially weak or failed ("zombie") servicers, have become obstacles in responding to the current wave of borrower defaults. Directors and officers of banks involved with loan participation investments need to re-examine bank credit policies, practices, and procedures and build effective collaboration and communications, as a group with other participants, to facilitate proactive decisionmaking to conserve collateral value.

Diagnosing the "zombie" trend

Due to a variety of factors that can contribute to lax credit administration practices and complacency, loan participation investments are often a neglected element of a loan portfolio with substantial financial and legal risks.

Here are three of the reasons why every bank director, officer, and commercial lender whose financial institution originates, sells, services, and/or purchases loan participations should have a better understanding of the challenges of this subset of banking:

1. Sloppy oversight yields future pain. Whether your bank is an originator/servicer or purchaser of a participation interest, failure to apply safe and sound credit practices to all aspects of loan participations can, among other things, subject your institution and its directors and officers to legal liability; create unintended legal lending limit violations and penalties; and bring on regulatory enforcement actions, expanded liquidity risks, and destroy bank capital

2. Regulators and accounting authorities are moving on this front. You can't stand still and hope these issues will

resolve themselves. Significant legal, financial, regulatory accounting, and financial reporting issues have arisen as a result of participant, servicer, and borrower defaults and bankruptcies; the application of FDIC receivership powers to failed institutions; purchases and assumptions of failed institutions coupled with FDIC loss sharing arrangements; and changes in financial accounting and reporting standards that became applicable Jan. 1, 2010 (FAS 140, 166 and 167), all of which are adding to the risks and complexity associated with these assets

3. Poor practices, uncorrected, will fester and hit the bank where it lives. Loan participations impact many key risk areas of your bank, including asset quality, liquidity, and loan concentrations. Directors, officers, and lenders, consistent with the duties and responsibilities associated with their respective roles, must focus on development and execution of safe and sound banking policies and procedures to avoid consequences of doing otherwise.

The attractiveness of participations is understandable. Investments in loan participations have been and will continue to be an efficient way to diversify loan risk and increase lender profitability without complicating borrower negotiations.

Many existing participation investments were made during robust economic times, without adequate consideration of their attendant complexities, costs, and risks under stress. These inherent problem areas have become painfully apparent during these times of borrower distress, due to the intensified demand for prompt communications, voting participation, and loan modifications. These issues challenge even the most seasoned and financially sound transaction originator/servicers and healthy, knowledgeable participation investors.

For those bankers who have investments in commercial real estate and hotel loan participations originated by failed institutions, the challenges of effective credit administration, including credit restructuring and/or monetizing those investments, have heightened the awareness of important elements and risks present in many participation agreements.

Understanding the basics of participation agreements

Legal counsel for the loan originator, whether an insured institution or not, prepares all of the documentation and typically serves only the interests of the originator, not the participants, as more clearly established by the Minnesota Supreme Court in the McIntosh County Bank vs. Dorsey & Whitney case involving a failed casino loan participation. (To read documents in this case, [click here](#).)

“Many very large deals have been documented with boilerplate contracts that may not be appropriate or well understood by participants,” observes Karen Grandstrand of Fredrikson & Byron, PA. She chairs the Minneapolis law firm’s banking practice.

The commercial real estate loan participation agreement defines the terms and conditions governing loan administration and establishes the respective relationships of the investor to the borrower, servicer, and the other participants. While the terms can be as unique as the imagination of the parties, common participation agreement provisions include:

1. A description of the fractional ownership, economic, and contractual interests of the participant, including payment flow; priorities and subordination, if any, in the underlying note; mortgage; and credit agreement, typically with no direct right of access to the borrower without prior consent of the originator/servicer.

2. The servicer’s duties, responsibilities, authority, and compensation, including limitations on possible changes in the event of borrower or servicer default.

3. Representations, warranties, and disclaimers of the originator, including exculpation from potential conflicts and liability in administering other credits to the borrower or related parties that may be adverse to the participants.

4. An affirmation by the investing participant that it has independently, and without reliance of any kind or nature on the originating lender and its officers, directors, attorneys, et al., made, and will continue to make, its own independent credit analysis and decisions with respect to the loan and the participation agreement.

5. Limitations on the credit administration rights and responsibilities of each participant, including limitations on the right to:

- a. Communicate independently with other participants without the consent of the servicer.
- b. Initiate or approve various changes to the credit agreement (s) proposed by the servicer.
- c. Change the servicer and reclaim the rights, duties and responsibilities associated therewith.

While in many instances, these provisions may be executed or overridden through majority or super-majority voting thresholds, even when met, their effect often slows participants' decision making and often obstructs sound and timely loan modifications to maximize collateral recovery.

Buying participations equal lending, not investing

The duties and responsibilities of each loan participation investor to exercise safe and sound banking practices are the same as for other credit decisions. These include adequate initial and continuing evaluation, documentation, authorization, and ongoing management of the credit and related credit risk until repaid.

That's the theory, anyhow. In actuality, for a variety of reasons, investor participants, acting individually or as a group, often rely implicitly on the loan originator and do not invest the resources to perform an independent assessment of the transaction by retaining independent legal counsel and expert business advisors to review the proposed credit.

While functioning independently may work well at the inception of a loan and participation investment, once a credit becomes stressed, the time, expense, and delays from each participant undertaking independent due diligence efforts, rather than as part of an independent group, can be substantial.

And in today's circumstances, matters can become complicate rather quickly.

"If the servicer actually fails, the servicing rights may end up in the hands of either a placeholder or a buyer with no knowledge of the credit, borrower, geographic area, etc.," says Hart Kuller of Winthrop & Weinstine, PA, Minneapolis. "Neither is a good situation for the participants." (Placeholders include organizations such as FDIC or a bankruptcy trustee or receiver.)

The new reality: lots of trouble

As the saying goes, "times change," and have they ever, triggering frustrations on the part of servicers, participants, and borrowers. Among the multitude of factors:

1. Projects failing to achieve original underwriting assumptions and projections, failing to make debt service payments or, in some cases, failing to cover operating costs;

2. Originating, servicing, and participating investor financial institutions being placed into an FDIC receivership or under regulatory agreements, resulting in:

- a. Staff turnover, lack of skilled servicing talent to handle defaults, and regulatory limitations.
- b. Failure of the participant or originating financial institution to meet its original obligation to advance additional funds.
- c. Added complexity and delays in decisionmaking, including accessing appropriate and authorized personnel.
- d. Absence of properly updated credit file information.
- e. Fire sale liquidations of participation and servicing interests of the failed institution.
- f. Risks that loans serviced by failed institutions acquired using FDIC loss-sharing agreements may be inadequately serviced for various reasons.

This would be bad enough, but there's more.

Well-qualified servicers and thoughtful, engaged loan participants have been hamstrung in pursuing solutions to distressed credit recovery due to:

1. Conflict among participating investors, caused by limited information; unconstructive attitudes; diverse and often conflicting motivations; and regulatory agreements, as well as myriad other restrictions, fears, beliefs, distractions, and priorities.

2. Absence of objective, independent analysis, constructive communication, and input to the servicer's efforts by the loan participants.

3. Failure to collaborate with other participants to achieve the requisite levels of voting power:

- a. To communicate and more quickly implement loan modifications through the servicer.
- b. To control servicing rights, thereby increasing the liquidity, marketability, and value of their respective fractional shares.

Inter-deal conflicts muddy potential solutions

With this background for why things can become so confused, let's explore the challenge of resolving problems with participated credits. Few circumstances are more frustrating to any servicer than attempting to coordinate an effective workout effort when participants' conflicting interests get in the way.

Participations present unique problems to servicers in that each participating institution has a unique perspective on how the situation should be addressed. In complying with the terms of the participation and servicing agreement, servicers often can be forced to do less than they would prefer or recommend when common ground can't be found.

Updated appraisals are a good example.

Although an updated appraisal might be appropriate, expected, or even required by various participants and their lending policies, a majority of participating investors might vote against the request. This then leaves the servicer to act against the express interests of at least some of its participants and the servicer's own judgment. In such instances, individual participants are then left with little practical choice other than to incur the expense of funding independent appraisals.

Another situation involves participants attempting to use intransigence as a tactic to have their interest bought out by larger participants.

Although most would say that the strategy is rarely effective and subjects the seller to a worse rather than better price, it nevertheless works to the detriment of all participants by causing unnecessary expense and opportunity cost in implementing appropriate solutions for maximizing and accelerating the recovery of the loan and often subjecting a project to additional risks and other costs arising from the delay.

So before rushing to blame the servicer, it is incumbent for all participants to ask themselves whether they are contributing to a solution or becoming part of the problem. [Click here](#) for some thoughts on cooperation through clarity and focus.

Regulatory considerations

A plethora of agency pronouncements apply to participations. In addition to some of the more specialized pronouncements of the moment—such as ["Concentrations of Commercial Real Estate,"](#) ["Prudent Commercial Real Estate Loan Workouts,"](#) and ["Guidance on OREO,"](#) there are a variety of other instructive materials and regulatory pronouncements concerning loan participations that are important to review, regardless of a respective loan's asset class or your financial institution's primary regulator. [Click here](#) for a list of the basics.

These are fundamental document, but there's more to the picture. Given the current economic climate, both federal and state regulators recognize the importance of practices that facilitate efficient, practical, and expedient credit administration for distressed or defaulted participation loans, as evidenced by OCC Interpretive Letters 1118 and 1123 regarding the organization of LLCs to hold title to defaulted OREO interests to accelerate and maximize the capital recovery.

State banking regulators have also been doing their part in recognizing some of the many challenges of collections efforts for participations. In the Midwest, for example, in December 2009, the Minnesota Commerce Department provided guidance concerning the conditions under which a Minnesota state-chartered bank may own a minority interest in an LLC organized solely for the purpose of holding OREO, received in satisfaction of a debt, from a loan participation entered into by Minnesota state banks, along with national and state banks of other states.

Given the variety of state law considerations that may come into play, it may be critical to have sophisticated, experienced bank regulatory and transaction legal counsel and asset specific business advisors provide guidance to your lenders in structuring each proposed participated loan recovery action plan.

An action plan for participation success

Regardless of the desire, the possibility, or the practicality of replacing a servicer whose performance may be unsatisfactory, the best way to protect the participants and the capital at risk may be to have an independent assessment completed to develop a game plan for maximizing and accelerating the recovery of the collateral irrespective of the current or proposed form and structure of the transaction.

With any distressed participation transaction, it is critical that the servicer and all participants be fully engaged in the loan stabilization, repayment, and capital preservation process.

Participation investor efforts for distressed credits should be built around a completely independent team of legal and expert business advisors charged with re-examining every element of the underlying credit.

As is true of any group with common interests, one of the participants has to take the initiative and volunteer for the leadership role on behalf of the participant group. Undertaking this role will generally involve significant time and the "group leader" should be compensated, much as if it were the primary servicer. Expectations and compensation of the group leader should be ratified in a formal agreement and accompanied by the written goals and objectives of the participants and a realistic, preliminary budget of the costs.

Ideally, the "group leader agreement" should include some type of voting protocols for group decisionmaking after appropriate fact finding and the recommendations and options have been presented by legal and business counsel to maximize recovery of the collateral.

Once elected, the group leader should engage knowledgeable, independent legal counsel with extensive loan participation and workout experience, with the respective asset class and transaction structure, to handle the following essentials:

1. Review the participation agreement and clearly communicate its terms and conditions that establish the framework for administration of the credit.
2. Review all project loan documentation, including the title insurance policy, loan closing instructions, and disbursement provisions (in the event of a construction loan), for any impediments to timely collection efforts, and any desired document remediation efforts.
3. Confirm compliance by each and all of the parties associated with the credit and the participation agreement.
4. Obtain and evaluate with the group leader, a current global credit and cash flow analysis of the borrower, related parties, and guarantors, if any.
5. Working with transaction legal counsel, identify knowledgeable, experienced, independent business advisors with workout experience to evaluate the property and its performance potential and develop business driven solutions for maximizing recovery of the credit.

6. When appropriate, request a current appraisal from an experienced appraiser with demonstrated expertise with the respective property type and market, including a written engagement letter requesting any additional evaluations or computations appropriate to the anticipated workout/recovery strategy for the property.

7. Obtain a current Phase I environmental assessment and, if possible, borrower representations about its knowledge, if any, of adverse environmental matters including its use of the property.

8. If the loan involves improved commercial real estate, obtain a property condition assessment evaluation by a knowledgeable, experienced expert to assess any physical or functional limitations about the improvements and the operating systems and compliance with existing (and possible code changes) building codes, possible capital expenditures required, and other regulatory agency licensing requirements.

9. Communicate the desires of the group to the servicer for discussion and execution of the agreed upon loan collection efforts.

The benefits of a collaborative approach

When discussing the possible choices and benefits of various recovery initiatives for a participation loan investment, a common question is: "So how much of an increased recovery might we expect from one approach versus another?"

Of course, the only legitimate answer to the question is: "It depends, as outcomes will vary from transaction to transaction based upon the unique facts and circumstances of each loan."

However, even the regulatory literature acknowledges the benefits of a unified approach. Consider this citation from OCC Interpretive Letter 1123, which states, in part:

"...the Bank proposes to exchange its participation interest in the OREO Properties for an interest in the LLC. Each of the other participating banks would exchange its interest, too, and in doing so the Bank believes that it, and the other banks, would be better able to recover the loan loss and dispose of the properties.

"Most significantly, the Bank represents that it likely would be unable to dispose of its interest in OREO properties apart from an agreement by all of the lending banks to jointly sell their interests.

"The Bank believes that an interest in the LLC would be more marketable, enabling the Bank to dispose of its interests prior to the LLC's ultimate disposition of the OREO Properties.

"By improving its ability to dispose of the property, the Bank in turn improves its ability to recover its loan loss.

"Also, rather than managing the OREO Properties according to the complex and burdensome terms of the loan

documents, aggregating the participation interests in the OREO Properties in the LLC permits the lending banks to designate one institution, the LLC's managing member, to address the day-to-day responsibilities of holding, managing, and negotiating the disposal of the OREO Properties. The Bank represents that it would recognize substantial cost savings through these efficiencies.

So regardless of the circumstances surrounding your loan participation investment, in the final analysis, this independent, group approach should produce greater speed, clarity, and objectivity in the decisionmaking process; be far more cost effective for all participants; and result in a much greater and quicker recovery than each investor attempting the "do-it-yourself" approach.

About the Authors

Dave Weir and Curt Petersen are partners and co-founders of Lenders Capital Resources (LCR), a professional commercial real estate loan advisory and contract workout services organization for financial institutions. The firm's services also include specialized credit recovery solutions for hotel loans/assets. Its leadership team offers more than 60 years of combined experience in diverse commercial real estate activities. You can learn more about the firm at www.lenderscapitalresources.com

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