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Will Businesses Be Protected?

Select Participation And Syndication Issues

by
Sara T. Toner[1]
Richards, Layton & Finger, P.A.

Commercial real estate finance has evolved from straightforward single lender/borrower structured loans into more complex, layered capital-market transactions involving multiple lenders. This "evolution" provides borrowers with access to larger-sized loans and permits banks to pool resources, allowing banks to enhance liquidity while spreading its risk and credit exposure. Lenders should be mindful of the structures and pitfalls involving loan participations and syndications, as hidden within these transactions are all sorts of risks that lenders should be aware of. While there are many benefits to participation and syndicated loan structures, parties should think about what will happen in the event of a borrower default. This article provides a primer on these structures and identifies key issues to be aware of.

The Basics: Participation Agreements

Let's start with the basics. A loan participation is an arrangement where a lender originates (the "lead lender") a loan to a borrower and then sells a portion of that loan to one or more other banks (the "participant"). A participation involves a separate loan transaction with the borrower and the lead lender on the one hand, and a participation agreement with the participant bank(s) and lead lender on the other, essentially creating two closings or transactions. The participation agreement creates the framework for the relationship between and among the lead lender and participant banks and governs the obligations each owes the other with respect to the loan. In a participation, the lead lender sources the loan with the borrower and is the named lender in the loan documents with the borrower. The participant bank is not named in the loan documents. It is important to recognize that a participant is not a lender and is not in privity with a borrower, agent or other lenders. Because the lead lender remains a lender for

the interest that is the subject of the participation, the lead lender remains responsible to the borrower and other lender participants as though the participation was not sold. Participants are not considered creditors of the borrower and cannot make claims against the borrower or the collateral securing the loan.

The role of the lead lender is active in nature, as this lender sources, manages and administers the loan. Typically the lead lender drafts the participation agreement. Since this structure facilitates the sale of the loan by the lead lender, the participation agreement is somewhat slanted in favor of the lead lender. The role of the participant is somewhat passive or behind the scenes in nature, as there is typically no interaction between the participant and the borrower. The participant lender funds a percentage of the loan amount, shares in the revenue derived from the loan, and assumes risk for the loan based on its percentage ownership of the loan. The terms are either *pari passu* or senior/subordinated. In a *pari passu* structure, the participants share the upside and downside of the loan equally. All payments are paid first to the lead lender, who then disperses to each participant in accordance with their respective participating interest. In a senior/subordinated structure, by contrast, the senior lender is paid first and the subordinate participation interest is paid only if there are sufficient funds left over to make the payments.

Key Benefits:

1. For the lead lender, a participation: (a) may satisfy lending needs of its borrower without exceeding lending limits, (b) provide risk diversification, and (c) improve the lead lender's liquidity position.

2. For the participant, a participation: (a) may supplement its loan portfolio when loan demand is weak, and (b) may reduce servicing burdens and origination costs while allowing the participant to make other investments.

When disputes arise they typically are the result of the banks involved in the participation having diverging views on the handling of the loan in the event of a borrower default. Many times the lead lender is the borrower's relationship bank, so it is not unusual for the lead lender to have a greater interest in working with the borrower than the participating bank. A well-drafted participation agreement may be difficult to litigate when things go awry because of the inherent sophistication of these agreements.[2] Courts strictly construe the language of participation agreements between the lead lender and the participants, citing the sophistication of the parties involved.[3] As such, if a borrower defaults and there are subsequent disputes arising out of the participation, courts will generally consider the terms of the participation agreement to determine the parties' rights and obligations. Duties and intentions generally will not be implied.

An overarching issue for participant lenders to be aware of is that the lead lender generally owes no fiduciary duties to a participant.[4] Delaware courts have not specifically addressed whether a lead lender owes a fiduciary duty to a participant.[5] Nationally, the prevailing view is encapsulated in *First Citizen's Federal Savings & Loan Assoc. v. Worthen Bank & Trust Co., N.A.*[6] In this case, a participant bank sued the lead lender for breach of fiduciary duty. The standard of care articulated in the applicable participation agreement was that the lead lender would "administer the loan in accordance with the same degree of care that the administrator would exercise in servicing and administering a loan of its own account." Applying California law, the United States Court of Appeals for the Ninth Circuit held that the participation agreement did not create a fiduciary duty, because the standard of care in the agreement was lower "than that ordinarily imposed on fiduciaries, who generally must exercise greater care in handling property with which they are entrusted than in handling their own." The holding of *First Citizen* is now the prevailing national view. Thus, a loan participation agreement will only create fiduciary duties if the parties expressly establish express duties within the four corners of the participation agreement.

A reliance disclaimer included in a participation agreement generally will be enforced by courts adding a further layer of protection for the lead lender in disputes arising out of the agreement. Keep in mind that most participation agreements will not obligate the lead lender to repurchase a participation interest in the event of a borrower default, and importantly, courts will not impose an obligation to repurchase when the agreement does not expressly provide for one.[7] Also noteworthy is that most participation agreements will not impose an independent duty on the lead lender to disclose information to a participant bank that the participant could have determined through its own due diligence.[8] Rather, independent analysis of the inherent risks of the credit is the sole obligation of the participant bank. A well-drafted participation agreement will expressly obligate the lead lender to promptly provide credit information about the borrower and notices regarding material changes affecting the borrower.

As borrower defaults typically are the most significant source of friction, the lead lender and participants should be mindful of how major enforcement decisions are addressed. Some agreements will obligate the lead lender to consult with participants about actions that address a borrower default, such as enforcement actions or modifying the loan. Other agreements provide that enforcement actions are the sole purview of the lead lender. When notice and consultation rights are provided, it is also important to think about decision and approval paralysis and how disputes are to be resolved when the lead lender and participating banks cannot agree on what to do. While most participation agreements will cover the initiation of an enforcement action once, for example, a foreclose has been filed, most participation agreements are silent on subsequent decision-making process and authority applicable to the enforcement process. Moreover, the flexibility to deal with the resolutions of a default, such as by a deed-in-lieu-of foreclosure or loan restructuring, may be extremely limited by restrictions and limitations in the participation agreement. For example, extensions of maturity, reductions in interest rates, waivers of payments or defaults, reductions in principal, or releases of security or guaranties may be restricted without the consent of each participant. These issues raise valuable drafting considerations to be mindful of when dealing with borrower defaults. In short, a well-drafted participation agreement is extremely important when a borrower defaults.

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The Basics: Syndicated Loans

Syndicated loans and participations share similar attributes—such as allowing a lender to make a larger loan to a borrower than a single lender may be able to provide—they are structurally quite different. A participation is essentially a sale of an interest in a loan. A syndicated loan, by contrast, is a joint endeavor where lenders join together as a group to offer a loan to a borrower. Thus, the syndication is documented in one transaction where the lenders and borrower are all in privity of contract with each of pursuant to the loan agreement. In syndicated loan documents, one lender is the lead lender and the other lenders are members of the syndicate. The roles of lenders in a syndicated loan may vary, but the typical participants include an arranging bank and an agent. The arranging bank is "the lead manager" who organizes the funding based on the term sheet. The bank must organize other lending parties who are willing to participate in the syndicate and share the lending risks. The agent in a syndicated loan serves as a link between the borrower and the lenders. The agent owes a contractual obligation to both the borrower and the lenders. The role of the agent to the lenders is to provide them with information that allows them to exercise their rights under the syndicated loan agreement.

Key Benefits:

1. Lenders initiating syndications may be able to increase profitability in transactions by bringing other lenders into the deal.
2. May provide an administrative ability that a lender may not have, such as administration of a construction loan.
3. Allows a bank to make a loan that is outside the scope of the lender's risk exposure. A syndicate allows lenders to spread the risk and share in the financial opportunity.
4. The liability of each lender is limited to their share of the total loan. The agreement for all members of the syndicate is contained in the loan agreement.

The form of loan documentation for a syndicated loan is the same as the documentation for a single lender, with certain key exceptions. The loan documentation will include the concept of the lead lender acting as agent for the lenders. This relationship is usually set forth in the loan agreement, which functions as the main contract for the relationship between the lenders and the borrower. The loan agreement also may include a provision that appoints the lead lender as the agent. While all lenders are a party to the loan documentation, only the agent interacts with the borrower; however, the loan documents will include obligations of the other lenders, such as advancing loan proceeds or situations where the syndicate lender group has consent rights.

Although the loan agreement typically contains the entire "deal" between and among the lenders and the borrower, there are times when the agent and lender syndicate group may enter into a separate co-lender or intercreditor agreement. Typical syndicated loan documentation will appoint the agent as the exclusive agent for the syndicate. Similar to a participation agreement, it is commonly provided that the agent does not owe fiduciary duties to the syndicate lenders. As the majority of the agent's responsibilities are administrative, the agent will not have liability to the other lenders for losses arising from the loan transaction. The loan documentation will impose restrictions on an agent's power to agree to specified amendments or waivers without lender consent. These may vary by transaction, but generally will include: (a) extension of interest, principal payment and maturity dates; (b) reduction of principal or the interest rate; (c) any write-off or increase in the principal amount; (d) release of any material portion of the collateral; (d) release of a borrower or any guarantor from any material obligations with respect to the loan; (e) consent to a material transfer that is not otherwise permitted by the loan documents; and (f) modification of lender consent rights or the definition of required lenders or majority lenders. There may be other restrictions on an agent's consent rights in light of the transaction type. For example, in construction loans, it is not unusual to see lender consent requirements related to significant changes in the project that could have an adverse effect on value or the construction budget. These consents or approvals may require unanimous majority or supermajority consents.

When disputes arise in a syndicated loan, the mechanisms for how to proceed are usually well defined. For example, removal of the agent is usually addressed but limited to gross negligence, willful misconduct or a breach by the agent of its obligations as agent. The loan agreement will typically specify consequences for a breach by a lender of its obligations. There are a variety of formulations, but generally the loan documentation will provide that if a lender defaults in its obligations, its voting and other rights are suspended and its right to receive payments is subordinated to the other lenders until the default is cured. This provision also may address the right of the other lenders to advance funds on the defaulting lender's behalf and the right of the non-defaulting lenders to purchase the defaulting lender's interest, sometimes at a discount. When a borrower defaults on a syndicated loan, communication between the agent and the other members of the lending group is critical to building the consensus required to address the defaulted borrower and maximize the lenders' recovery. Collaborating on a strategy to address a defaulted loan with a diverse syndicate group of lenders can be daunting. In a situation where a borrower defaults, decision-making by the agent and syndicate can be crucially important. It is better to consider these issues at the outset. As a member of a group of syndicate lenders, the ideal time to address decision-making is at loan origination.

Conclusion

Participation and syndication agreements can be lucrative alternatives to traditional commercial finance. While each provides significant advantages to lenders, there are pitfalls and issues to be aware of with each structure. Whether a lender is considering a loan participation or a syndication, it should approach any such transaction prudently and perform its own due diligence on both the borrower and the lead bank. Careful drafting and consideration of what could happen when/if a borrower defaults is an important part of considering the risks and potential rewards offered by these structures.

Sara T. Toner is chair of the Real Estate Group of Richards, Layton & Finger, Delaware's largest law firm. She has substantial experience in real estate finance, asset-based lending, loan modifications, and workouts and restructurings, with particular focus on structuring and negotiating commercial mortgage loans. Ms. Toner acts on behalf of lenders, borrowers, and other providers of debt and equity capital across all asset classes in connection with commercial real estate transactions and finance, including traditional, portfolio commercial mortgage structures as well as non-recourse, CMBS, mezzanine financing, and other leveraged finance structures.

Ms. Toner advises clients regarding the acquisition, sale, lease, and development of commercial real estate properties in Delaware and throughout the U.S. She is proficient in obtaining approvals and resolving disputes in land use matters, both in an advisory capacity and before zoning boards and planning commissions. Also experienced in the formation of limited liability companies for the acquisition and development of real estate, Ms. Toner provides advice with respect to LLCs regarding formation, drafting of operating agreements, and member disputes.

Notes:

1- Sara T. Toner is a director of Richards, Layton & Finger, P.A. The views expressed in this article are those of the author and not necessarily those of Richards, Layton & Finger or its clients.

2- *See Northwest Bank & Trust Co. v. First Ill. Nat'l Bank*, 354 F.3d 721, 726 (8th Cir. 2003).

3- *See New Bank of New England v. Toronto-Dominion Bank*, 768 F. Supp. 1017, 102 (S.D. N.Y. 1991).

4- *See Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 53 (2d Cir. 1992); Banco Urquijo, S.A. v. Signet Bank/ Maryland, 861 F. Supp. 1220, 1249 (M.D. Pa. 1994) ("a fiduciary relationship does not arise from a lender participation agreement unless the agreement expressly provides for such a relationship").

5- While Delaware courts have not specifically addressed this issue, applying New York law in *Vornado PS, L.L.C. v. Primestone Inv. Partners, L.P.*, 821 A.2d 296, 322 (Del. Ch. 2002), aff'd, 822 A.2d 397 (Del. 2003), the Chancery Court addressed lender obligations owed to debtors and stated that under "New York law 'no fiduciary duty aris[es] out of the contractual arms' length debtor and creditor relationship' between a borrower and a lender."

6- *First Citizen's Federal Savings & Loan Assoc. v. Worthen Bank & Trust Co., N.A.* 919 F.2d 510 (1990).

7- *See First Citizens Fed. Savings and Loan Ass'n v. Worthen Bank & Trust Co. N.A.*, 919 F.2d 510, 514 (9yh Cir. 1990).

8- *Banco Espanol de Credito* 973 F.2d at 56.