What happens to the loan participation agreement when the "loan" is no more?

By John Lockett

Loan participation agreements (LPAs) are common tools used by banks to spread their risks, be it risk to a particular borrower or, if the loan is secured by real estate, risk in a particular locale. However, LPAs can sometimes be a source of disputes between banks. One of the most common types of LPA disputes are disagreements between the "lead bank" and a "participant bank" over how the loan should be administered once it goes into default.

Typically, the LPA will set forth a standard to which the lead bank will be held in administering the loan. Examples of commonly used standards are that the lead bank will administer the loan in a "commercially reasonable manner," or that the lead bank will administer the loan in a "prudent manner," or that the lead bank will treat the participant's interest in the loan as if it were its own, and occasionally, that the lead bank owes the participant fiduciary duties with respect to the participant's interest.

Furthermore, LPAs also set forth rules regarding when major decisions regarding the loan (*i.e.*, declaring a default, filing suit, foreclosing on collateral, *etc*.) can be made. Some LPAs give the lead bank absolute discretion in these matters, while others give those powers to the owners of a majority interest in the loan, while still others require a unanimous vote among the owners of the loan.

However, I recently had a case that presented two unique issues. To what standard will the lead bank be held once the loan is written off and the real estate collateral becomes "other real estate owned" a/k/a "OREO"? And who has the right to sell the OREO?

In this particular case, the LPA provided that the lead bank would administer the loan and the collateral with the "care of a prudent man" and provided that the owners of a majority of the loan could release collateral. But of course, as every banker knows, once real estate has been foreclosed upon and becomes OREO, the real estate is no longer “collateral” because it no longer secures a loan. Unfortunately, the LPA in my case was silent on what standard the lead bank would be held to regarding the disposition of OREO, or even if the lead bank had the right to sell the OREO without the unanimous consent of the participants.

This raised some very thorny questions. What exactly is the relationship between the lead bank and its participants with regards to the OREO? Does the LPA still govern? If not, are the lead bank and participants now partners? Are fiduciary duties owed to the participants by the lead bank? As you may imagine, opinions on these issues differed.

Fortunately, the parties in my case were able to resolve their dispute. However, the dispute could have been avoided entirely if the LPA in question had specified how the loan would be administered after it was written off and the collateral became OREO. Banks that use LPAs (as either a lead bank or a participant) should make sure that their LPAs specify what will occur in this particular scenario even if it means deviating from “form” agreements that have been commonly used in the past. It is often much easier to resolve these issues at the outset of a participation relationship, when everyone is in a friendly mood, than it is to litigate them after the loan is in default and the mood has soured.

John Lockett is a partner in the commercial litigation group of Morris, Manning & Martin, LLP. He can be reached at 404-233-7000 and JLockett@mmmlaw.com. This article is for informational purposes only and should not be construed as being legal advice.