# Loan Participations: Participants' Claims Against Lead Lenders

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Purchasing participations in loans originated and administered by a lead lender is attractive to the participant for several reasons, such as allowing it to diversify and expand its loan portfolio without having to invest in the infrastructure necessary to find and service the loans. *See In re Okura & Co. (America), Inc.*, 249 B.R. 596 (Bankr. S.D.N.Y. 2000). Participations, however, do not insulate participants from the risks associated with bad loans and a participant may not always be content to leave the management of such risks to the lead lender's discretion. Not surprisingly then, tensions between them may arise when their shared loan or its borrower encounters trouble. Perhaps the participant will disagree with the lead lender's decision to forbear rather than to foreclose or may believe that the lead lender did not earlier disclose to it the loan's potential risks. Sometimes these disputes lead to litigation.

This article will highlight several principles relevant to a participant's rights against the lead lender, as well as review how courts have responded to claims brought by participants alleging that the lead lender (a) administered the loan to the participant's detriment or (b) failed to disclose material information prior to the participation's purchase. In many cases, the participant has sought to cast the lead lender as its "fiduciary" with a heightened responsibility to protect its interests. These claims are typically pursued on theories of either contract or tort and therefore decided under state law applicable to the particular participation.

## OVERVIEW OF PARTICIPATIONS

A participation is a contractual arrangement in which one lender (the lead lender) makes a loan to a borrower and then sells a share (i.e., an undivided beneficial interest) in that loan (usually, but not always, retaining a share for itself) to another lender (the participant). *See First Nat'l Bank v. Continental Ill. Nat'l Bank & Trust Co.*, 933 F.2d 466 (7th Cir. 1991); *see also In re Coronet Capital Co.*, 142 B.R. 78 (Bankr. S.D.N.Y. 1992) (discussing the circumstances when such a transaction will not be deemed a "true" participation, but rather a loan by one lender to another, thereby creating a debtor-creditor relationship between them). Since their relationship is created by contract, "the parties to a participation agreement may choose whatever terms they wish and the agreement will generally be enforced as to its terms". *In re Autostyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). Participants and lead lenders customarily document their understanding in either (or both) a participation agreement or participation certificate, which will control the rights and duties between them, including the participation's repayment. *See In Re Continental Resources Corp.*, 799 F.2d 622 (10th Cir. 1986).

Unlike a joint or syndicated loan, where each lender makes a loan directly to the borrower and is in contractual privity with it, the participant's only contractual relationship is with the lead lender. As a result, a participant is not a creditor of the borrower or entitled to assert claims against it. *See Natwest USA Credit Corp. v. Alco Standard Corp.*, 858 F.Supp. 401 (S.D.N.Y. 1994). Only the lead lender has the right to collect and enforce payment by the borrower or any guarantors, hold and enforce security interests in the borrower's assets or otherwise administer the borrower's loan. *See In re Columbia Pacific Mortg. Inc.*, 20 B.R. 259 (Bankr. W.D. Wash. 1981). The participant can look only to the lead lender for the repayment of its participation, and usually only upon the lead lender's receipt of payment from the borrower. *See Hibernia Nat'l Bank v. FDIC*, 733 F.2d 1403 (10th Cir. 1984). The participant and lead lender typically agree to share those payments as made and in proportion to their respective interests in the loan. *See In re Coronet Capital Co., supra.*

If the borrower defaults in the loan's payment, the participant will normally

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have no recourse against the lead lender for the participation's outstanding balance other than a right to receive its stipulated share of amounts the lead lender ultimately recovers from the borrower, any guarantors and the liquidation of any available collateral. *See In re Sackman Mortg. Corp.*, 158 B.R. 926 (Bankr. S.D.N.Y. 1993). Such limited recourse, however, will not preclude the participant from seeking redress against the lead lender for its breach of specific provisions in their participation agreement or certificate. *See People's Heritage Savs. Bank v. Recoll Mgmt., Inc.*, 814 F.Supp. 159 (D. Me. 1993).

## LEAD LENDER'S ADMINISTRATION OF LOAN

While they share a common interest in the loan's repayment, a participant and lead lender may not always agree as how to best protect that interest. Upon a borrower's default, for instance, the lead lender may want to restructure the loan's payment terms whereas the participant would prefer that the loan be immediately called and enforced. The participant's rights to influence or control that decision, as well as others that arise in the loan's course will generally exist only to the extent set forth in the participation agreement or certificate. *See Northern Trust Co. v. FDIC*, 619 F.Supp. 1340 (W.D. Okla. 1985). Thus, if the participation agreement either expressly empowers the lead lender to restructure the loan without the borrower's consent or is silent as to the participant's right to influence that decision, the participant most likely will be "powerless to do anything about it". *See Mansura State Bank v. Southwest Nat'l Bank*, 549 So.2d 1276 (La. Ct. App. 1989); *In re Continental Resources Corp., supra*, 799 F.2d 622.

A court's reluctance to impose any rights or duties between participants and lead lenders beyond those expressly agreed to between them is illustrated by *Colorado State Bank v. FDIC*, 671 F.Supp. 706 (D. Colo. 1987). In that case, the court refused to find any implied duty on the part of the lead lender to take steps to enforce a note upon the borrower's default to protect a participant's 100% interest, noting that the only duty owed by the lead lender to the participant under their agreement was to pay over to the participant any payments it received. *See also First Bank of WaKeeney v. Peoples State Bank*, 758 P.2d 236 (Kan. Ct. App. 1988) ("in the absence of a negotiated contract term, the lead bank exercises sole control over the collection and enforcement of the loan").

Courts have also not been receptive to a participant's claim that the lead lender's actions, while expressly permitted under their agreement, nevertheless constituted a breach of the implied covenant of good faith and fair dealing. *See People's Heritage Savs. Bank v. Recoll Mgmt, Inc., supra*, 814 F.Supp 159; *Royal Bank of Canada v. FDIC*, 733 F.Supp 1091 (N.D. Tex. 1990). In *Firstar Metro. Bank & Trust v. FDIC*, 964 F.Supp. 1353 (D. Ariz. 1997), however, the lead lender had agreed in the participation agreement that it would be liable to the participant for its acts of gross negligence or willful misconduct. The court, therefore, refused to dismiss the participants' contractual claim for the breach of the implied covenant of good faith and fair dealing provided the participant alleged the lead lender's gross negligence or willful misconduct in breaching that duty.

In several cases, the participation agreement or certificate at issue has been equivocal as to whether the lead lender could take a specific action without the participant's consent. The lead lender in many of those cases has prevailed because its challenged actions were perceived by the court to have been taken in furtherance of the best interest of those lenders holding a majority share (in term of dollars) in the loan. For example, in *Carondelet Savs. & Loan Ass'n v. Citizens Savs. and Loan Ass'n*, 604 F.2d 464 (7th Cir. 1979), a minority participant in a mortgage loan alleged the lead lender had failed to timely foreclose on the real estate. In holding in the lead lender's favor, the court noted that the participation agreement "as a whole" clearly intended to grant the lead lender a great deal of discretion and that, in any event, the lead lender's alleged delay was not unreasonable, but rather a good faith effort to salvage the loan. Similarly, in *Mark Twain Bank v. Continental Bank, N.A.*, 817 F.Supp. 792 (E.D. Mo. 1993), a minority participant challenged the lead lender's decision to extend interim payment dates without its consent (but with that of the other participants). The court found the participation agreement to be "ambiguous" but construed it in a manner favorable to the lead lender and other participants, explaining that "[i]t would be ludicrous for one [p]articipant with a $5 million share of the $85 million loan to be able to jeopardize the interests of the [l]enders (of the remaining $80 million) as [plaintiff] proposes". *See also First Nat'l Bank, supra*, 933 F.2d 466 (the interests of the lenders to a participated loan often diverge upon a default and allowing the majority to prevail is not "so bad").

Lead lenders have not always been successful, at least at the summary judgment stage, in having an ambiguous agreement construed in their favor. In *Den norske Bank AS v. First Nat'l Bank of Boston*, 75 F.3d 49 (1st Cir. 1996), the First Circuit vacated the district court's grant of summary judgment dismissing the participant's claim alleging that the lead lender had restructured a defaulted loan over its objection and on terms that effectively reduced the participant's ultimate recovery. The First Circuit held the participation agreement to be ambiguous as to whether the lead lender intended to

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grant the participant the right to veto such an arrangement. In remanding the case for trial, the court further found that the participant was entitled to offer expert testimony in support of its contention that, at the time it purchased the participation, the common "industry-wide" practice was to incorporate into participation agreements a minority participant's right to veto any "loan forgiveness".

Notwithstanding its breach of the participation agreement or certificate, the lead lender's liability to the participant for such breach may be limited by the terms of their agreement. *See American Bank & Trust v. FDIC*, 49 F.3d 1064 (5th Cir. 1995) (enforcing participant's agreement that lead lender shall have no liability for its acts or omissions provided the lead lender acted in good faith); *Continental Bank N.A. v. Old Kent Bank & Trust Co.*, 1994 U.S. Dist. LEXIS 18177 (N.D. Ill. 1994) (enforcing participant's agreement that lead lender's liability to participant is limited only to acts of "gross negligence or willful misconduct"). As succinctly stated by the Ninth Circuit "there is no law against parties to a contract relieving themselves of liability by contract, particularly when they are sophisticated institutions represented by knowledgeable counsel". *Chemical Bank v. Security Pac. Nat'l Bank*, 20 F.3d 375 (9th Cir. 1994). Notwithstanding the parties' freedom of contract, contractual provisions exonerating a party from any liability for its willful or grossly negligent acts may be unenforceable on public policy grounds. *See Gross v. Sweet*, 400 N.E. 2d 306 (N.Y. Ct. App. 1979) (discussing New York law).

## LEAD LENDER AS FIDUCIARY

Courts usually agree that where the parties to a participation are sophisticated financial institutions, no fiduciary relationship between them will be implied. *See Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146 (2d Cir. 1995) (hereinafter, "Banque Arabe") (in a loan participation, "there is deemed to be no fiduciary relationship unless expressly and unequivocally created by contract"); *First Bank of WaKeeney, supra*, 758 P.2d 236 ("participation agreements are arms-length contracts between relatively sophisticated financial institutions and do not establish fiduciary relationships . . ."); *but see Carondelet Savs. & Loan Ass'n, supra*, 604 F.2d 464 (lead bank was a "dominant fiduciary" under Illinois law but did not breach fiduciary duties owed to participant). Courts also agree that a participant and lead lender are free between themselves to voluntarily create a fiduciary relationship by their contract. *See Guaranty Savs. & Loan Ass'n v. Ultimate Savs. Bank, FSB*, 737 F.Supp. 366 (W.D. Va. 1990).

In deciding whether the lead lender has voluntarily assumed a fiduciary responsibility to the participant, some courts have required " unequivocal language" in the parties' agreement expressing such intent. *See First Citizens Fed. Savs. & Loan Ass'n v. Worthern Bank and Trust Co., N.A.*, 906 F.2d 427 (9th Cir. 1990). In *Chemical Bank, supra*, 20 F.3d 375, the agreement among the banks in a joint loan transaction described the lead lender as an "agent", but made no express reference to any fiduciary relationship or fiduciary duties. The Ninth Circuit, nonetheless, found that "[t]he very meaning of being an agent is assuming fiduciary duties to one's principal" and held that lead lender owed fiduciary duties to the other banks that it breached by failing to properly perfect their security interest in the collateral. Other courts have declined to find that the lead lender's designation as an agent for the participant is sufficient to create a fiduciary relationship. *See First Nat'l Bank v. Mercantile Bank of Kansas City*, 1989 U.S. Dist. LEXIS 15768 (D. Kan. 1989) ("the fact that a participation agreement creates an agency does not necessarily mean that a lead bank owes a fiduciary duty to the participant"); *Northern Trust Co. v. FDIC, supra*, 619 F.Supp. 1340 ("the fact that the lead bank holds title while acting as an agent for the participant does not render the agent a trustee for the participant").

A breach of assumed fiduciary responsibilities may have severe consequences to the lead lender. In *Women's Fed. Savs. & Loan Ass'n v. Nevada Nat'l Bank*, 811 F.2d 1255 (9th Cir. 1987), the lead lender agreed that it would act as a "trustee with fiduciary duties" to protect the participant's interest. The lead lender was found to have breached its fiduciary duty of loyalty by (1) concealing from the participant the borrower's deteriorating financial condition and (2) making additional loans to the borrower that were not disclosed to the participant. As a result, the participant was entitled both to rescind the participation agreement and to have the lead lender disgorge any profits it received from the undisclosed loans.

Even where it is fiduciary by agreement, the lead lender's liability to the participant in that capacity may be limited by that same agreement. *See Chemical Bank, supra*. Moreover, many lead lenders now routinely include language in their participation agreements or certificates whereby the participant will acknowledge that the lead lender is not a fiduciary.

## LEAD LENDER'S NON-DISCLOSURE

Participants are required to investigate and decide for themselves the risks that they may face if they purchase a participation in the lead lender's loan. *See Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992). Indeed, if the participant is a bank, national and many state

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banking regulations will require it to make its own independent credit investigation as to the borrower. *See Office of the Comptroller of the Currency Banking Circular No. 181* (Aug. 2, 1984). In the absence of a fiduciary relationship between them (discussed above), a lead lender's duty to disclose information to the participant will exist only to the extent it is either mandated by their agreement or imposed by law.

Participation agreements, however, often contain provisions either specifically disclaiming any duty on the lead lender's part to make disclosures to the participant or narrowly limiting the scope of disclosures to be made. Additionally, the participant usually will acknowledge in that agreement, with varying degrees of specificity, that it has not relied upon the lead lender or information provided by it in purchasing the participation. In many instances, the lead lender has been able to invoke specific contractual disclaimers to defeat a participant's tort claim against it based upon non-disclusure. *See Bank of the West v. Valley Nat'l Bank,* 41 F.3d 471 (9th Cir. 1994); *Northwest Bank & Trust Co. v. First Illinois Nat'l Bank*, 221 F.Supp. 2d. 1000 (S.D. Iowa 2002).

The lead lender may not be permitted to invoke contractual disclaimers to defeat a participant's claim alleging non-disclosure where the undisclosed facts could not otherwise have been discovered by the participant and an affirmative duty to disclose such facts was imposed by law upon the lead lender. *See Bank of Montreal v. Signet Bank*, 193 F.3d 818 (4th Cir. 1999) (discussing Virginia law); *Banque Arabe, supra*, 57 F.3d 146 (discussing New York law). The circumstances where an affirmative disclosure duty may be imposed by law includes those when (1) disclosure is necessary to complete or clarify the lead lender's partial or misleading statements to the participant; or (2) the lead lender possesses superior knowledge of material facts not readily available to the participant and the lead lender is aware that the participant is acting on the basis of a mistaken belief as to those facts. *Id.* The lead lender's breach of a disclosure duty imposed by law may constitute a fraud upon the participant if the other elements of fraud are proven (i.e., materiality, scienter, reliance and damages). *Id.*

## CONCLUSION

The weak economy and current headlines suggest that participants will continue both to suffer losses from their participation in loans gone bad and to look to their attorneys for ways to hold the lead lender responsible for at least a portion of those losses. Some attorneys will respond pessimistically, advising that lead lenders more often than not by a wide margin have successfully defended against participants' claims in the past. Other attorneys will respond optimistically, counseling that the precise contract terms, specific facts and controlling law may vary from case to case. None of those attorneys can be said to be wrong and the courts will ultimately determine which ones were right.