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Participation Pitfalls—Seven Questions Every Mortgage Loan Participant Should Ask

by Malcolm K. Montgomery*

Introduction

The mortgage loan participation market in the United States has never been healthier. While conventional wisdom would suggest that most mortgage loans are being sold into the commercial mortgage backed securities (CMBS) market, a surprisingly large number of loans are being held for syndication, and many of those syndications are being effected via participations rather than assignments. Both forms of syndication allow the lead banks to move loan assets off their balance sheets while accommodating the borrowing needs of major clients, increasing fee income and expanding loan origination volume. Purchasers find such syndications equally attractive as a reasonably steady stream of new loan product. Syndicated loans also give purchasers access to potentially lucrative new borrowers and new markets. Moreover, purchasers do not have to establish and maintain offices or loan origination teams except to the extent their direct business needs require. Purchasers also may base their decisions to purchase in part on the lead bank's underwriting expertise.

Participations have been a common feature of the U.S. real estate lending market for well over a century. But during that time, what have prospective mortgage loan participants really learned about the pitfalls of purchasing participation interests? There are seven basic questions that should be asked by and answered to the satisfaction of every prospective mortgage loan participant. Be forewarned, however, that mortgage loan transactions can be quite complex and participation agreements are notoriously incomplete. As a consequence, inattentive participants often assume greater risks than they realize.

1. Do the loan documents match the term sheet?

The first area of inquiry lies not with the participation agreement, but with the summary of terms or "term sheet" for the deal. The term sheet usually arrives in the office of a prospective participant atop several feet of newly minted loan documents. One is tempted to read the term sheet, verify the interest rate specified in the note and, assuming the lead lender was represented by competent counsel, assume that the balance of the loan documents accurately reflect the terms of the deal. The only problem with this approach is that "the deal" typically evolves over time and the term sheet almost never represents the final deal that the lead lender cut with the borrower. A term sheet is by definition a mere summary of the proposed transaction prepared at the outset of the negotiations. Significant negotiations may occur between the date of the term sheet and the signing of the loan documents. Events of default may have been eliminated, financial or other covenants may have been altered, leasing reserve requirements may have been reduced and other concessions may have been made. None of these changes may have been of material significance to the lead lender, but they may be of great significance to the participant's assessment of the risks associated with buying into the deal. But the participant will never have the opportunity to identify and

* Mr. Montgomery is a partner with Shearman & Sterling LLP. If you have any questions concerning this article, please contact him at 212.848.7587 or mmontgomery@shearman.com.

weigh those risks without a close inspection of the loan documents and a clear understanding of how the final loan documents work.

Generally, prospective participants are given copies of fully executed documents and told, essentially, that no changes to the documentation will be forthcoming. Those who have represented borrowers, however, know that lead lenders often reserve the right to require changes to loan documents in order to permit syndication to occur. Thus, if a prospective participant has substantive issues with the documentation, it should apprise the lead lender of its issues as other participants may have raised similar issues and changes may indeed be possible.

2. Should this participation be an assignment?

There are two customary methods of syndicating a mortgage loan: participations and assignments. Ownership of the loan stays with the lead lender in a participation and the borrower generally has no direct contact or contractual privity with the participant. Borrowers tend to prefer this arrangement, as they avoid the burdens of dealing directly with multiple lenders in respect of a single mortgage loan. In contrast, ownership of all or a portion of a loan is sold outright to the assignee in an assignment, and the assignee becomes a party to the loan agreement and a direct lender to the borrower. Assignments have become more common today than participations for three principal reasons. First, assignments may result in more favorable treatment to the lead lender under applicable capital adequacy rules. Second, some lenders (German mortgage banks being a prime example) may be subject to regulations or internal banking guidelines requiring that each loan investment represent a direct claim against the borrower and the real estate collateral, making the purchase of a participation interest (in which, as a legal matter, the participant's claim is derivative of the lead lender's claim) *verboten*! Third, and perhaps most importantly, many real estate lenders still bear the scars of the last downturn in the U.S. real estate lending market and may have internal policies that bar the purchase of a participation in lieu of an assignment. In view of this growing preference by lenders for purchasing assignments rather than participations, borrowers have gradually become more willing to accept syndication through assignments.

Notwithstanding these market forces, borrowers still prefer participations over assignments and many mortgage loans today are still packaged, marketed and sold through the participation format. Participations remain especially common in the "club" context, in which members of the loan syndicate are banks well known to one another who regularly do business together across many product lines. As a consequence, some of the lessons learned by mortgage loan participants over the last ten to twelve years remain relevant.

3. To what standard of care is the lead lender held?

Although lead lenders retain significant control over the administration of loans, courts generally will not read a fiduciary relationship into a participation agreement between two sophisticated lending institutions represented by counsel in the absence of express contractual language creating such a relationship. If a participation agreement specifically provides for a fiduciary or trust relationship between the lead lender and the participants, the lead lender is required to act in the best interests of the participants and otherwise in accordance with the requirements imposed on fiduciaries under the common law. Such requirements include, among other things, an obligation to act with the utmost good faith, loyalty and honesty toward the participants and with the level of care and skill "standard in the locality" for lead lenders in mortgage loan facilities. Moreover, if the lead lender that acts as a fiduciary possesses any special skills, it will be obligated to employ such skills in carrying out its duties.

Most participation agreements, however, expressly negate a fiduciary standard. For legal and practical reasons, lead lenders look to assume only those duties and standards of conduct that are expressly delineated in a participation

agreement. Accordingly, participation agreements typically contain "exculpation" provisions disclaiming any fiduciary relationship and thereby bypassing the duties and responsibilities automatically imposed under common law on those acting as fiduciaries. A typical exculpation clause will include a disclaimer by the lead lender for all liability except to the extent caused by the lead lender's gross negligence or willful misconduct. The lead lender also will be absolved from liability for any actions taken with the approval of a majority of the members of the lending syndicate. Finally, each participant will be required to acknowledge that it did not rely on the lead lender's credit risk analysis and has instead undertaken its own independent analysis of the transaction.

Participation agreements are generally construed as arm's-length contractual agreements that will be enforced in accordance with their terms. In the vast majority of cases, therefore, courts will respect and enforce exculpation provisions that limit a lead lender's liability to participants, even when such provisions are broadly written. Participants should have such provisions reviewed and negotiated by knowledgeable counsel and should never assume that a lead lender will have any liabilities or special responsibilities to participants in the absence of gross negligence or other egregious conduct by the lead lender.

4. What decisions require the participant's approval?

A typical participation agreement provides that the lead lender retains the exclusive right (subject to a specific list of limitations) to modify the loan documents, issue consents and waivers, enforce remedies and otherwise administer the loan. There will then follow a list of actions that the lead lender is not permitted to take without the consent of each participant. Such actions will ordinarily include:

- Any extension of the maturity date or reduction in the principal amount of the loan;
- Any reduction in the interest rate or extension of the time of payment of debt service on the loan;
- Any release or termination of any guaranty of the loan; and
- Any release of collateral for the loan.

Indeed, these listed items are often spelled out in the loan documents as the only actions as to which participants may have consent rights. The typical participation agreement will then go on to specify that decisions as to which remedies to pursue following an event of default will be made in accordance with the vote of syndicate members (including the lead lender) holding percentage interests in the loan accounting for at least 51 percent. Participants are often allotted a relatively brief period (e.g., five business days) within which to respond to requests from the lead lender for consent and, in the case of a failure to respond or, in some participation agreements, "an emergency", the lead lender will reserve the right to act on its own.

Against this backdrop, a participant should carefully consider whether there are certain categories of remedies in the context of a particular transaction (e.g., electing to pursue a lengthy lawsuit against a guarantor in lieu of a mortgage foreclosure) that should require the vote of a higher percentage of syndicate members. Further, participants should consider how many syndicate members the lead lender (or any other party) would need to buy out in order to gain effective control of the entire syndicate. If the likelihood is high that one party could gain voting control, consideration should be given to adjusting the voting threshold (to 66 percent, for example) in the case where one syndicate member individually holds a 51 percent interest in the loan or more.

In setting the voting percentages and, indeed, determining the items on which voting should be required, the participant must weigh the risk of being outvoted against the (arguably more hazardous) "holdout" risk. The latter is the risk that one or more holdouts (or syndicate members that seemingly refuse to approve any course of action at all) can cause a lending syndicate to become paralyzed by reason of having

set the percentage vote needed to approve the exercise of remedies too high. The holdout problem also arises when a lead lender must make decisions on significant matters not contemplated by, and not otherwise adequately addressed in, the participation agreement. In such cases, the lead lender often concludes that the course of action least likely to result in personal liability for the lead lender is to obtain the unanimous approval of the participants. As any real estate banker who survived the early 1990s will attest, however, obtaining such a consensus is often impossible. Thus, participants must take a balanced view as to the decision-making provisions of the agreement.

5. Are sub-participations or further assignments permitted?

The availability of sub-participations or further assignments of interests by syndicate members raises two issues. First, if a loan is very broadly syndicated (either initially or by reason of subsequent transfers of interests), the voting power of individual participants will be diluted, which may make the loan difficult to administer when syndicate member consents must be obtained. Second, restrictions on sub-participations and further assignments may result in a participant holding an illiquid investment, which may conflict with an institution's internal policies or investment guidelines.

Participation agreements often expressly prohibit sub-participations and further assignments without the written consent of the lead lender. An alert prospective participant should require that the lead lender agree in advance not to unreasonably withhold or delay consent to such a transaction or, better still, agree to set forth parameters within the participation agreement describing parties to whom assignments or sub-participations will be permitted without consent. The prospective participant should also carefully screen the loan agreement for restrictions on assignments and sub-participations that may conflict with the negotiated terms of the participation agreement, as the more restrictive terms of the loan agreement would govern in the event of such a conflict.

6. Does the lead lender have a conflict of interest?

Lead lenders often have significant relationships with their borrowers and affiliates of their borrowers, spanning numerous financing and other transactions. Indeed, one great advantage to loan syndication for the lead lender is that it permits a single institution act as the lead on many more transactions than would be possible were the institution (and its balance sheet) required to carry all of the transactions by itself. Sometimes these relationships can span more than one independent divisions or departments within the lead lender's organization and may include, for example, M&A advisory services or assisting with the placement or issuance of debt or equity securities. The relationship of the participant with the borrower is often not as broad or varied. Accordingly, the risks associated with relying on a lead lender burdened by numerous, and possibly conflicting, relationships with the borrower and its affiliates should be considered and understood by the participant. The scope of such relationships will not be apparent on the face of the term sheet or loan documents. Thus, a participant should seek a description from the lead lender of the nature and extent of the lead lender's relationships with the borrower and its affiliates. Of course, such a review cannot foresee changes to the lead lender/borrower relationship that may develop following purchase of the participation interest.

In one clear-cut example of a potential conflict of interest, a lead lender may hold a separate subordinate loan (which may take the form of a second mortgage loan or a mezzanine loan) to the same borrower or the parent entity of the borrower. In such circumstances, any foreclosure by the lead lender (on behalf of the syndicate) of the senior loan could well eradicate any chance of recovery on its separate subordinate loan. Any participant considering investing in such a senior loan would be well advised to consider the added risk that comes with relying on a lead lender with this type of conflict. The one certainty in a transaction so structured is that any workout will be lengthy and punctuated by intra-bank group squabbles.

A similar conflict can arise in the context of interest rate hedge transactions. It is not unusual for the borrower of a syndicated floating rate loan to enter into a separate interest rate swap, cap or collar with the lead lender in the transaction. The loan documents may even provide that the obligations of the borrower under the hedge documents are secured by the mortgage on the property. The loan documents may or may not subordinate the claims of the lead lender under the hedge documents to the claims of the syndicate members in respect of the loan. If such claims are not subordinated, then the inattentive participant may be surprised to find that after a default it must share recoveries on its collateral with the interest rate hedge provider.

A well-drafted participation agreement should establish a procedure whereby the lead lender can, in the event of a conflict of interest or other appropriate circumstance, resign as lead lender. The agreement could provide, for example, for the appointment of an independent administrative agent (who acts at the direction of the majority in interest of the syndicate members) to administer the loan. Such provisions should also address how any such administrative agent would be compensated. The end result would protect both the syndicate members and a lead lender facing the potential liabilities attendant to a serious conflict of interest.

7. How will decisions be made in a workout or bankruptcy?

A well-drafted participation agreement is particularly important in the context of a workout of a loan gone sour. The resolution of a defaulted loan is often complex and can present issues that are addressed only vaguely in a participation agreement. This lack of detail is not surprising given that participation agreements are prepared in connection with a syndication of interests in the loan – exactly the time at which the lead lender would rather not focus extensive attention on the prospect of the loan going bad. Moreover, workouts often raise very transaction-specific issues that are hard to discuss and address in advance. As a workout can often lead to a Chapter 11 bankruptcy filing (whether by design of the parties or as a defensive measure) by the borrower, the participation agreement should address in a reasonably detailed manner the rights and obligations of the lead lender and the other syndicate members in the event of a borrower insolvency.

Even when decision-making in a workout scenario is addressed in some fashion, a lending syndicate can quickly find itself in territory that had not been contemplated by the drafter of the participation agreement. To take a straight-forward example, a borrower may offer to convey the mortgaged property to the lead lender in exchange for extinguishing the loan. In such circumstances, it is not uncommon to discover that one or more syndicate members have no interest in owning (or delegating to the lead lender responsibility for owning) the property. Worse yet, the participation agreement either may not address the acquisition of the property with sufficient specificity or may grant the lead lender full discretion to acquire the property and manage and otherwise deal with it so long as the net proceeds (whatever they may be) ultimately realized on an eventual sale are shared with the participants on a *pro rata* basis. While the typical participation agreement can be expected to specify in some detail how decisions are to be made in the context of exercising remedies, it may not address with adequate specificity how the syndicate is to make decisions once “the keys have been taken back” and important decisions must be made with regard to the management and sale of the asset. The end result may be a paralyzed (or angry) group of participants.

Recent bankruptcy court decisions have held that a “true loan participation” does not result in a partial assignment of the lead lender’s right to payment from the borrower. As a consequence, bankruptcy courts have concluded that participants are not entitled to “creditor” status in a borrower’s Chapter 11 bankruptcy case and that the lead lender, as the party recognized as the creditor “with the sole right to seek legal recourse against the borrower” (a reading which can be confirmed by the terms of most participation agreements), retains the exclusive right to assert a claim in the bankruptcy case. Accordingly, if the

participation agreement fails to adequately address how the lending syndicate's claim will be voted and otherwise dealt with in a bankruptcy, the participant can quickly find itself disenfranchised and demoted to a mere spectator in the case. Pre-agreed or so-called "prepackaged" bankruptcy plans of reorganization often result from difficult workout scenarios. Only a participant that preserves its voting rights in a bankruptcy case can expect to participate in the structuring of the plan of reorganization rather than being relegated to the sidelines.

Although it is both unrealistic and impracticable to expect any participation agreement to cover every eventuality, a well-drafted participation agreement should set forth the basic ground rules governing the making of those decisions that commonly arise in a workout or bankruptcy context.

Conclusion

Making generalized statements about the terms of mortgage loan participation agreements is nearly impossible. The terms of such agreements can vary substantially from institution to institution and from transaction to transaction. While some uniformities exist, the resolution of any issue of significance will turn upon the specific language of the governing agreement. A prospective participant evaluating a mortgage loan should closely inspect the terms of the participation agreement and underlying loan documents proffered by the lead lender, considering along the way each of the potential pitfalls discussed above. Adopting a prudent approach at the outset of the transaction will better ensure that the participant is compensated for the risks it assumes and that there are no unpleasant surprises down the road.

About the Author

Malcolm K. Montgomery is a partner in the Property Group of Shearman & Sterling LLP. Real estate finance transactions handled by Mr. Montgomery include, among others, multi-state secured credit facilities and mezzanine construction financings, real estate investment fund subscription financings, debt portfolio financings and hotel and resort financings. Mr. Montgomery recently represented Eurohypo AG in the first-ever syndicated subscription financing of a European real estate development fund. Mr. Montgomery received his B.A. from Princeton University in 1986 and his J.D. from New York University in 1989. He is a member of the Real Estate Financing Committee of the New York State Bar Association Real Property Section and the International Investment in Real Estate Committee of the American Bar Association. Mr. Montgomery can be reached at +1.212.848.7587 or mmontgomery@shearman.com.

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For more information on the topics covered in this issue, please contact:

Malcolm K. Montgomery
New York
+1.212.848.7587
mmontgomery@shearman.com

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