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Participation Loans Get Even More Complicated

Law360, New York (April 10, 2014, 10:43 PM ET) -- Since 2008, almost 500 banks have failed. These banks held billions of dollars of loans. Among these billions of dollars of loans are many participation loans where the failed bank was the lead bank with administration rights for the loan. These participation loans can present unique complications when an institution acquires the lead position from the Federal Deposit Insurance Corporation and there is disagreement among the participants about the administration of the loan.

A recent appellate court decision was issued that makes such participation loans even more complicated. This decision significantly affects both the financial institutions in participation loans where a failed bank was formerly the lead bank on the loan, and the FDIC.

Participation Loans

Generally speaking, a participation loan is a loan where multiple lenders maintain an interest or share in the loan. One lender — generally the majority interest holder in the loan and called the “lead bank” — has the administration rights of the loan. As such, the lead bank is responsible for servicing and administering the loan.

The rights and obligations of the lenders in the participation loan are governed by a participation agreement. Many participation agreements include an ipso facto (“by the fact itself”) provision, which permits the lender that is the most senior minority interest holder in the loan to assume the administration rights on the loan from the lead bank under certain events, such as the insolvency or takeover of the lead bank by a governmental agency.

FIRREA and 12 U.S.C. § 1821(e)(13)(A)

The Financial Institutions Reform, Recovery and Enforcement Act provides, among other things, broad protections to the FDIC when it comes to preserving the value of the assets of failed banks. For instance, one provision — 12 U.S.C. § 1821(e)(13)(A) — allows the FDIC to enforce a contract of the failed bank notwithstanding any provision in the contract “providing for termination, default, acceleration or exercise of rights upon” insolvency or the appointment of a receiver.

This provision of FIRREA, for example, has been used by the FDIC to enforce a failed bank’s lease of its office space, even though the lease stated that it terminates if the tenant-bank becomes insolvent.[1] The FDIC has also relied on this provision of FIRREA to enforce a participation agreement where the lead bank failed, and prevent a minority interest holder from assuming administration rights for the loan.[2]

As a result of 12 U.S.C. § 1821(e)(13)(A) and the broad protections given to the FDIC by FIRREA, acquiring banks generally have been protected from ipso facto provisions in participation agreements that permit minority interest holders to remove the lead bank if it fails. On March 12, 2014, however, the Georgia Court of Appeals issued a decision that could significantly affect the rights of the acquiring banks and minority interest holders in participation loans, as well as the FDIC.

CRE Venture 2011-1 LLC v. First Citizens Bank of Georgia and the Challenge to Acquiring Banks

In CRE Venture 2011-1 LLC v. First Citizens Bank of Georgia,[3] the Georgia Court of Appeals affirmed a preliminary injunction issued in favor of a minority interest holder in a participation loan preventing the acquiring institution with administration rights from foreclosing on the collateral securing the loan. The injunction issued even though the acquiring lead institution and the other larger minority interest holders wanted to foreclose on the collateral.

Importantly, the lead institution acquired its interest in the loan from the FDIC, as receiver for a failed bank. The court held that the statutory protections for the FDIC in FIRREA (specifically, 12 U.S.C. § 1821(e)(13)(A)) did not apply to the acquiring lead institution, and therefore, the minority participant could exercise rights under the participation agreement to assume administration rights under the loan as a result of the failure of the original lead bank.

In 2010, Crescent Bank & Trust Co. was the majority interest holder and, as the lead bank, held the administration rights in a participation loan. First Citizens Bank of Georgia was a minority participant in the loan. Crescent failed in late July 2010, and the FDIC was appointed as receiver.

In August 2011, CRE Venture 2011-1 LLC purchased Crescent's interest in the loan. Soon thereafter, the borrower defaulted, and CRE began the steps to foreclose on the collateral. Two other minority interest holders (both of whom also had purchased their interests in the loan from the FDIC, as receiver for two other failed banks) agreed with the foreclosure plan. First Citizens, however, objected to the foreclosure plan and wanted to pursue a workout of the loan.

First Citizens filed suit against CRE and sought an injunction preventing the foreclosure. The suit also sought a declaratory judgment that the failure of Crescent triggered First Citizens' right under the ipso facto provision in the participation agreement to remove the administrator (now CRE) and assume administration rights for the loan. (The ipso facto provision permitted a minority participant to assume administration rights for the loan if the lead bank, Crescent, was declared insolvent or taken over by a governmental agency.)

CRE's primary defense in the case was based on 12 U.S.C. § 1821(e)(13)(A) and the cases where the FDIC relied on this provision in FIRREA to enforce contracts of failed banks. The Georgia Court of Appeals, however, stated that it was "not persuaded" that acquiring institutions such as CRE, as the purchaser of an asset from the FDIC, had the authority to rely on 12 U.S.C. § 1821(e)(13)(A) in the same manner that the FDIC, as receiver, could do so to avoid contractual liabilities.

A primary purpose of FIRREA and the FDIC's powers thereunder is to preserve the value of failed banks. As a result, the Georgia Court of Appeals addressed the issue of whether enforcing the ipso facto provision of the participation agreement against the acquiring institution and thereby removing its administration rights would negatively affect the value of the assets of the failed bank.

Contrary to CRE's position that a foreclosure was the most prudent course of action, First Citizens introduced evidence that a workout of the loan would increase the value of the institutions' interests in the loan. The Court of Appeals relied on this evidence from First Citizens, and stated that enforcing the ipso facto provision against the acquiring institution may increase the value of the loan.

CRE also argued that First Citizens had effectively waived its right to assume the role as administrator because it waited so long after CRE acquired its lead position in the loan to invoke the ipso facto provision. Indeed, CRE had acquired its rights in the loan in August 2011, yet First Citizens did not attempt to exercise its rights under the ipso facto provision until more than a year later, on the eve of the temporary restraining order hearing. In a footnote, the Court of Appeals held that this defense did not apply.

In affirming the trial court's decision to issue a preliminary injunction, the Court of Appeals stated that the record supported a finding that First Citizens will lose some of the value of its minority interest in the loan if CRE foreclosed on the collateral. Most troubling to acquiring institutions, the court further held that the harm to First Citizens outweighed any harm to CRE because CRE, like most acquiring institutions, purchased its lead interest in the loan at a discount from the FDIC.

Lastly, the court held that there was a substantial likelihood that First Citizens would prevail on the merits of its claim to assume the administration rights under the loan based on the ipso facto provision.

The Impact On All Players in Participation Loans

CRE is seeking certiorari from the Georgia Supreme Court. Although future cases will depend on the language in the participation agreement, this decision affects all players in participation loans where the lead institution acquired its interest from the FDIC, as receiver.

1. Acquiring Institutions That Acquired Their Lead Interests From the FDIC, As Receiver — These lead institutions cannot assume that 12 U.S.C. § 1821(e)(13)(A) will permit them to avoid the application of ipso facto provisions based on the failing of the prior lead bank. As a result, and notwithstanding loan administration provisions in the participation agreement, these lead banks will need to work more with minority participant banks on important decisions relating to loan administration given the minority participant bank's potential ability to assume administration rights under the participation agreement.

2. Institutions Considering Acquiring Lead Interests in Participation Loans From the FDIC, As Receiver — These institutions will need to include the minority participant's potential ability to succeed to administration rights among the factors to consider in whether to purchase the lead interest from the FDIC.

This potential ability of the minority participant may affect the purchase price of the lead interest, or even whether an institution will purchase the interest at all. In addition, these institutions will likely consider requiring minority participants to execute an appropriate amendment to the participation agreement protecting the new lead institution from the ipso facto provision as a condition of the purchase of the lead interest.

3. Minority Participant Banks — These banks will now likely attempt to exert more influence over administration of the participation loan given the threat of a suit to enjoin actions of the lead institution based on the ipso facto provision. These banks will use CRE Venture as support for efforts to remove the lead institution as administrator where it acquired its interest from the FDIC, as receiver, in situations where the minority participant is unhappy with the administration of the underlying loan or plans to dispose of the collateral.

4. The FDIC — The FDIC is likely to see institutions interested in purchasing lead interests in participated loans either (a) offering less to purchase the lead interest knowing that the administration rights may be subject to ipso facto provisions, or (b) requesting that the FDIC take action to enforce the participation agreement (thereby exercising its rights under 12 U.S.C. § 1821(e)(13)(A) to avoid the ipso facto provision) or to obtain waivers of the ipso facto provisions directly from the minority participants.

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[1] Iberiabank v. Beneva 41-I LLC, 701 F.3d 916 (11th Cir. 2012).

[2] Devonshire Park LLC v. FDIC, No. 8:08-cv-2083-T-AEP, 2010 WL 7325248 (M.D. Fla., July 23, 2010).

[3] No. A13A1888, 2014 WL 943227 (Ga. Ct. App., March 12, 2014).
