

# Publications

## Issues in Participation Agreements, Continued

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### AUTHORED ARTICLE | Spring 2014

*The Bankers' Statement* – Spring 2014

Published in the Spring 2014 issue of *The Bankers' Statement*

Following our bulletin on this topic of more than a year ago, we continue to encounter situations with clients involving the accounting and regulatory treatment of certain loan participations. Given the widespread use of loan participations, and the potential serious problems that may arise from having to reclassify participations in regulatory call reports or published financial statements (including potential regulatory issues that may result), we felt it appropriate to revisit participation agreements to provide an update on the issue.

Almost all banks will, from time to time, sell participation interests in loans to a participating bank, and such sales typically are evidenced by a participation agreement between the originating (selling) bank and the participating (purchasing) bank. In virtually every case, the intent of the originating and participating banks is that the participation will be treated as a sale of the participated loan interest from the originating bank to the participating bank. Recently, however, issues have been raised by accountants and regulators regarding certain provisions contained in participation agreements that may be inconsistent with the intended treatment of the participations as a "true sale." In such cases, unless the participation agreements can be (and are in fact) amended to remove the offending provisions, the participations may need to be reclassified as "secured borrowings" and put back on the originating bank's balance sheet.

There are two provisions in participation agreements that can pose particular concerns. The first provision involves the right or option of the originating bank to repurchase or buy-back the participated loan interest from the participating bank. Alternatively, the provision may give the participating bank the right to "put" the participated loan interest back to the originating bank. Such provisions are sometimes referred to as "optionality provisions," and can create problems with the treatment of the participation as a "true sale" under certain circumstances. This is certainly the case where the exercise of the originating bank's right to repurchase, or the participating bank's right

to put, is unilateral. However, it can also be problematic when the repurchase or put right is conditioned upon breaches or other events. For example, at least one banking agency has taken the position that, to meet the requirements of "true sale" treatment, a participation agreement must limit breaches by the originating bank (which allow the participating bank to "put" the participation back to the originating bank) to:

- (a) A breach of its representations of warranties to the participating bank that the loan documents that are the subject of the participation interest being transferred are what they are represented to be;
- (b) A breach of its obligation, if applicable, to service the loan and administer the loan documents and the participation interest; or
- (c) A breach of its obligation to share any setoff benefits with the participating bank.

The second provision that is creating problems imposes restrictions on the ability of the participating bank to assign or otherwise transfer its participation interest to a third party. Generally, such restrictions will not negate "true sale" treatment if a provision simply restricts an assignment or transfer without the originating bank's consent, so long as such consent may not be unreasonably withheld, or restricts an assignment or transfer to a competing institution (so long as other willing buyers exist). However, other prohibitions and restrictions can be problematic if they have the effect of constraining the participating bank from transferring or exchanging the participation interest.

Ultimately, whether the existence of an optionality or restriction on transfer provision in a participation agreement negates "true sale" treatment from an accounting standpoint is an accounting issue. However, the treatment of the participation interest as other than a "true sale" could be a potentially significant problem for many banks, especially smaller banks that enter into numerous participation agreements to avoid issues regarding loans to one borrower. It could also be a significant issue for banks that may be required to restate prior call reports and, in some instances, financial statement filings by SEC registrants. Finally, such treatment could have regulatory capital implications as a result of the originating bank being required to put the participated loan interests back on its balance sheet.

Participation agreements typically contain a clear statement of the intention of the originating bank and the participating bank that the participation shall be treated as a sale of the participated loan interest (and may further provide that the originating bank's title to the participation interest in the loan is conveyed to the participating bank, and that nothing in the participation agreement shall be construed as creating any relationship of debtor and creditor between the originating bank and the participating bank). Participation agreements often contain a provision that if any change in generally accepted accounting principles made effective subsequent to the date of the participation agreement would result in the treatment of the transaction as being other than the purchase and sale of a participation interest in the loan, the parties will agree to negotiate in good faith any necessary amendment to the participation agreement or modifications to the transaction to preserve the original intent of the parties, which is to accomplish a purchase and sale of a participation interest in the loan. While these provisions can be helpful in justifying an amendment to the participation agreement, they typically will not overcome accounting or agency positions that the very existence of an optionality provision or restriction on transfer in the participation agreement negates the "true sale" treatment of the participation.

It is important to note that contrary treatment of participations can result not only in issues with regard to call report and financial statement accuracy, but also issues with regard to bank debt covenants, Troubled Asset Relief Program commitments, capital requirements and "loan-to-one-borrower" limitations, as discussed above.

The foregoing items represent issues that we have encountered in certain transactions for clients, but should not be considered as an exhaustive list of issues related to the treatment of participation interests. We suggest that institutions with potential concerns regarding the treatment of participation agreements consult with their accountants and legal counsel to confirm that the participation transaction in question (or their "standard forms" of participation agreements) continue to merit "true sale" treatment of the participated interests, and that the participations are being appropriately reflected in the bank's financial statements.