Publications

Client Alert: Participation Agreements: Originator Beware

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In recent examinations, the FDIC has identified issues arising from the existence of "optionality" provisions in participation agreements that provide the originating lender with the *option* of repurchasing the participated portion of the loan upon a borrower default. Such "optionality" provisions have been determined to cause the interest sold by the originating lender to be classified as a "secured borrowing" rather than constituting a "true sale" of the participation interest under applicable accounting guidance. Accountants and auditors may well react likewise in recommending restatements with respect to the institution's previously issued financial statements and call reports, and categorization of the participation interests as "secured borrowings" in future financial statements and call report filings subject to amendment of participation documents discussed below.

In these circumstances, the FDIC may, depending on materiality, also require participation originators to file restated call reports to reflect the change in classification. Call report restatements can, in turn, lead to the determination that the financial statements included in filings made by publicly traded financial institutions and financial holding companies with the Securities and Exchange Commission and/or state securities regulators, or in pending registration statements or made available to potential investors in connection with pending offerings, must be restated and the related securities filings amended.

Reclassifying the participation interest as "secured borrowing" by the originating lender can also result in "loan to one borrower" issues as well as, in some instances, Reg O issues depending on the nature of the credit, the impact of aggregation rules, and nature of the borrower. Covered individuals employed at institutions participating in federal programs and initiatives such as SPLF and TARP may also be impacted by restated financial results that, in turn, impact compensation previously earned and received (i.e. through a mandatory "clawback"). In addition, originating institutions with participation interests that are held by the FDIC as receiver for a failed institution may, due to the failed institution's own circumstances, be forced to accept significantly reduced loan settlement payments as a result of the failure of the FDIC to recognize the "optionality" provision.

Originating institutions should consult with their legal, accounting and credit professionals to evaluate whether it may be appropriate to amend existing participation agreements, as well as participation agreements that may be entered into in the future, to eliminate "optionality" provisions that afford a repurchase option for the originator. However, even if amendments are adopted with regard to outstanding participations, the FDIC may still require classification and restatement with respect to the related participations by the originating institution.