Purchasing Loan Participations: The Devil is in the Details

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This article explores the use of junior participations and some common pitfalls to avoid when purchasing a junior participation in a senior loan.

As the real estate financing market has grown more sophisticated and populated with an increasingly diverse roster of players, the issuance of loan participations have become more and more common. Participations provide both a means for an originating lender to lay off risk and better leverage its balance sheet, while also providing an avenue for other financial institutions and investors to invest in real estate debt in amounts, at yields and with the associated risks better suited for their respective investment profiles than buying or originating whole loans.

What is a Loan Participation?

The term ''participation'' commonly refers to an undivided fractional interest and participation in a loan, along with the interest and fees paid. This is in contrast to another popular structure where the loan is split into separate A and B loans, each with its separate promissory note.

The originator of the loan, commonly the senior participant, is the one selling junior participations. The junior participation interest is often evidenced by a participation certificate setting forth the percentage of the participation owned by the junior participant, so that it is not characterized or mistaken for the creation of a debtor-creditor relationship between the junior and senior participants, and the nature of this transaction must be made very clear in the operative documents. In addition, as this is an undivided interest, there is no need to perfect a security interest in the loan.

The participation structure may be used for senior loans and mezzanine loans, and has only one promissory note from the underlying borrower, which is secured by a first mortgage on the applicable commercial real property or, for mezzanine loans, a pledge of the equity interests in the property owner. The contractual rights and obligations of the junior participant and the senior participant, including the distribution of loan proceeds, decision making rights and cure rights, is contained in the participation and servicing agreement (the ''Participation Agreement'').

This article explores the use of junior participations and some common pitfalls to avoid in the context of the purchase of a junior participation in a senior loan. The purchase of the junior participation could occur at the time of the creation of the junior participation, in which event the seller would likely be the senior participant, or could be a resale by the original holder/purchaser of the junior participation.

Current Trends

At the time of their creation, junior participation interests are priced according to their level of subordination, to account for the increased risk as the participant moves further down the capital stack. The senior participant subsidizes additional interest payments to the junior participants over and above a *pro rata* portion of the interest rate on the note. This is in contrast to the pricing of senior participations, which might command a premium to reflect their more secure position.

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In a resale of a junior participation in the current market, however, discounts can be expected on many of the participations originated in recent years due to a variety of factors:

Market Changes

The decline in the credit markets in recent months has caused spreads to widen and the availability of leverage to decrease. A subordinated interest in a senior loan originated in 2007 with, say, an interest rate of 1.5 percent over LIBOR and leverage of 80 percent will not be sufficiently attractive to attract capital in the current market at the discounts that previously prevailed. These market changes would require greater discounts in the participation's purchase price to appeal to a purchaser.

Borrower Defaults; Changes in Loan-to-Value

An increasing number of commercial loans have potential or actual borrower defaults or are non-performing. Even if a default has not occurred, the underlying property may have decreased in value since the origination of the loan, thus resulting in a deteriorating loan-to-value ratio. In each of these situations the increased risk to the junior participant would be compensated through a discount in the participation's purchase price.

Liquidity Needs of the Holders

In today's environment, many loan holders are under significant pressure to reduce their holdings of commercial loans, including junior participations. Therefore, the holders of the participation interests may be highly motivated to quickly sell their interests and would be willing to grant discounts of 10 percent to 25 percent or more to facilitate this. Such pressure to sell interests in commercial loans, combined with discounts due to market changes, increasing borrower defaults and decreases in property values, has created a significant buying opportunity for purchasers with available capital.

Senior Participant Fees

When negotiating the purchase of a junior participation, consider any origination and servicing fees charged by the senior participant as the lead lender. While these fees may represent added value to the loan by the senior participant, they also represent, especially if these fees are above market, or if a third party servicer is also used, added negotiating room for the purchaser to obtain an additional purchase discount.

Purchases of Junior Participations

Choosing a senior participant is critical to the success of the participation. The senior participant is often the administrative agent and responsible for day-to-day administration of the loan. It may also have the right to choose the servicer of the loan.

Fully investigate the senior participant, who should share the investment goals of the junior participant and have similar underwriting standards and tolerance for risk. The personal relationship of the individuals at the respective lending entities is also material to the success of the participation.

Another consideration is the creditworthiness of the senior and other participants. This is especially critical with construction or other loans which have future funding obligations, although any project may require protective advances if it starts to turn bad. If the senior and other participants are unable to comply with their financial obligations, then the project could be a failure. In the current market climate, the fear of lender liability lawsuits for funding defaults looms large. In any event, the Participation Agreement should make clear that the junior participant is only required to make its *pro rata* share of future funding obligations and protective advances. Alternatively, the junior participant could have the option of stepping up and matching any advances that the defaulting participants did not make, provided that any such advance is granted a super-priority and/or a higher rate of return.

There may be additional consequences to a junior participant from the insolvency of the senior participant. The bankruptcy or receivership of the senior participant could lead to the potential waiver of obligations of the senior participant under the loan and the Participation Agreement, including potential future funding defaults. Most chilling is the possible failure to distribute funds received from the borrower according to the payment waterfall in the Participation Agreement.

What can happen if a bankruptcy court re-characterizes the participation as a loan to the senior participant? If the relationship between the junior and senior participant is re-characterized as a ''loan'' by the junior participant to the senior participant, the trustee in a bankruptcy is likely to have the ability to hold all proceeds of the loan as part of the bankruptcy estate of the senior participant, and the junior participant would merely be an unsecured creditor forced to share any loan proceeds, *pro rata*, with the other unsecured creditors. This position could put the junior participant in jeopardy of losing its entire investment should the senior participant's estate be depleted by its secured creditors.

How can a junior participant avoid re-characterization and losing access to the loan proceeds in the event the senior participant becomes bankrupt? The junior participant should make sure that the purchase of the participation complies with the ''true sale'' criteria set forth by the Financial Accounting Standards Board (''FASB''). Generally, it is important that the senior participant truly part with all of the risks

and benefits of the junior participation and it must be clear in the Participation Agreement that the junior participant has a say in all substantive/material decisions made in connection with the loan.[1]

Most Participation Agreements entered into today have incorporated the FASB criteria and added provisions necessary to protect the junior participants and avoid the possibility of re-characterization of the participation structure. That being said, it is extremely important that those buying a junior participation make sure the FASB criteria are encompassed in the Participation Agreement. Although the concept of a participation is understood in the market to be an arms-length transaction where the participants share in the proceeds of a mortgage or mezzanine loan, the absence of these criteria in the text of the Participation Agreement could lead to a loss of the junior participant's investment at the hands of the bankruptcy court.

Representations and Warranties

Within the Participation Agreement, the seller provides the purchaser of the junior participation with various representations and warranties regarding the loan, including customary due authorization and organizational representations. Among the areas that should, at a minimum, be addressed include the senior participant being the sole legal owner and holder of the loan, free and clear of any lien, pledge or other adverse interest in the loan, and that the seller has the right to sell the junior participation to the purchaser.

The outstanding principal balance and accrued interest of the loan and the amount and nature of each reserve held under the loan must be included and there must be no undisclosed subordinate mortgages encumbering the related mortgaged property. With mezzanine loans, there must not be any undisclosed encumbrances relating to any direct equity interests in the borrower or its direct owners, nor any preferred equity interests held by the senior participant.

Also, there must not be any monetary or non-monetary defaults or breaches existing under the loan or potential defaults or breaches, nor can the loan have been modified, canceled or subordinated in any manner. Finally, a schedule of all loan documents should be included in the Participation Agreement and a representation that complete copies of each have been delivered to the purchaser must be made.

Keep in mind that these representations should be no less thorough than those the purchasing junior participant may be required to make in any subsequent sale of its participation.

Due Diligence

The purchaser will be required to perform its own legal and financial due diligence, which is critical. The desired level of due diligence will be determined by the adequacy of the representations and warranties given by the seller of the junior participation. Even with representations from the selling participant, there is no better way to protect yourself than doing your own diligence.

Include the borrower in the due diligence. Run searches on all entities or individuals with a 20 percent or more ownership interest in the borrower, as well as any entity or individual which has a management or decision making role with respect to the borrower. These searches should include bankruptcy searches, judgment and litigation searches and Patriot Act searches, along with basic financial due diligence on the borrower and its principals and any guarantor, including obtaining financial statements that have been updated since the original closing.

Perform all customary property level due diligence as if you were originating the loan. This includes, but is not limited to, review of title and survey, property management agreements, leases and environmental reports. Any prudent investor would also require estoppel certificates from all major tenants at the property. The seller of the participation should supply any environmental, engineering, zoning and other property reports in its possession.

Each property type has its own individual due diligence quirks. For example, if the investment is in a new construction loan, special attention must be paid to insurance and the draw on funds requirements. With a multi-family residential property, the purchaser should obtain a current rent roll and rental delinquency report from the borrower. If the property is a condominium, be sure the originator of the loan complied with all mortgagee provisions in the condominium declaration and a look at the condominium declaration and the condominiums by-laws, as well as any pending condominium unit sale contracts, is prudent.

If hotels are included, the purchaser will want to review the franchise agreement and be sure it runs to successors and/or assigns. The purchaser should also try to obtain a recognition agreement from the hotel flag.

Office buildings require the purchaser to obtain a schedule of tenant improvement obligations of the borrower, while with shopping centers, the creditworthiness of the anchor tenants should be examined.

Perform a thorough review of all existing documentation on the loan, as well as the documentation for any subordinate debt, including any intercreditor or co-lending agreement, and the Participation Agreement. For a mezzanine loan, review compliance with perfection of the security interest in the pledged equity interests under Article 8 of the Uniform Commercial Code. And thoroughly review the status of all escrow accounts held by the lender and any prior principal draw downs.

Payment Waterfalls

A purchaser of a junior participation needs to care-

fully review the provisions of the Participation Agreement relating to the allocation of funds received under the loan. The basic payment structure behind a loan participation is that the senior participants get their *pro rata* piece of the pie before the junior participants receive their *pro rata* share of the loan, but only so long as the loan is performing. In contrast, when the loan is in default, the junior participant will not get any return of its investment until after all payments of costs, advances, principal repayments and accrued interest are made to the senior participant.

The Participation Agreement provides for various buckets to be filled in the payment waterfall when funds are received by the administrative agent or servicer. Prior to an event of default under the loan, the typical waterfall provides that the senior participant will first be reimbursed for any costs and advances and interest, paid its scheduled interest payments at the participant's stated interest rate and paid its *pro rata* share of any principal paid, whether scheduled amortization or prepayments.

This is followed by the junior participant being reimbursed for any costs and advances and interest, paid its scheduled interest payments at the stated interest rate and also paid its *pro rata* share of any principal paid, whether scheduled amortization or prepayments.

Then, to the senior and junior participants, on a *pro rata* and *pari passu* basis, (i) interest at the default rate, (ii) any prepayment premium actually received and (iii) any extension fee or assumption fee received.

What happens during a default? There is really only one change to the waterfall during the continuance of a default and it is crippling for the junior participants. The bucket for the repayment of the principal balance due to the senior participant needs to be paid down to zero before any funds can be used to make any other payments. The senior participant must be paid in full prior to any funds becoming available to any junior participant. However, the junior participant which is the controlling holder does have cure rights (as discussed below) available to it in order to stop this scenario from playing out.

What changes can a junior participant request to protect it? A well-negotiated Participation Agreement could limit the types of defaults that will cause a change in the payment waterfall, so that only material monetary and material non-monetary defaults will trigger a change in payment priority, and only after any cure period granted the junior participant has run. Another point that could become critical is the repayment priority of protective advances. Whether or not an event of default exists, a junior participant should attempt to have its contribution to protective advances paid prior to any participant receiving payment for interest or principal and, ideally, *pari passu* with the senior participant. This is especially critical in the situation where a loan is not fully advanced, such as a construction loan, as a junior participant would not want to advance funds to a project in default unless they were treated as protective advances having priority in repayment and not as advances of loan principal, which would be paid much further down the waterfall, if at all, in a troubled project.

Level of Control: Controlling Holder or Passive Investor

It is critical to determine prior to purchasing a participation interest the junior participant's degree of control under the participated loan. There are three possible levels of control:

(i) The most junior participant will be the controlling holder;

(ii) Decision making will be by the consent of a majority-in-interest of participants; or

(iii) The junior participants will be passive investors except possibly for certain decisions requiring unanimous consent or super-majority consent.

In each case, the rights of the junior participant will be detailed in the Participation Agreement.

Controlling Holder

What is the controlling holder? In simple terms, the ''controlling holder'' is the member of the participant class that typically has a right to consent to certain major decisions in connection with the loan but does not usually have the right to compel the senior participant, administrative agent or servicer to take any action. This is in contrast to the senior participant or administrative agent, which remains responsible for the day-to-day administration of the loan, often in conjunction with a third party servicer, typically according to a servicing standard defined in the Participation Agreement.

Who is the controlling holder? In a typical participation transaction, the controlling holder is the most subordinate of the junior participants until such time as there is a ''control appraisal event,'' as discussed below, when the senior participant assumes the rights and duties of the controlling holder.

The powers of the controlling holder vary from deal to deal based on how much the senior participant wants/needs a particular participant in a deal. In today's market, a broad range of consent rights and consultation rights can be negotiated, even in some cases the right to compel certain actions, especially in the critical area of enforcement of remedies. For example, a senior participant of a loan secured by a hotel which is struggling would likely be open to granting broader rights/powers to a controlling holder/junior participant that has experience operating hotel properties. A discussion of major decision and consultation rights follows below.

In today's trying secondary mortgage market, where commercial mortgage-backed security lenders have been caught with loans on their books that cannot be

securitized and need to be reduced, we are seeing purchasers of junior participations enjoying a stronger negotiating position by expanding the powers and rights of the controlling holder. This gives the junior participant, in its role as the controlling holder, more control over its investment by allowing it to speed up the enforcement of certain remedies thereby preventing any delay in the recovery of its investment.

Loss of Control: the Control Appraisal Event

A ''control appraisal'' event customarily occurs when the value of the junior participation has declined to a point where it is worth less than 25 percent of par. The value of the note is determined by an appraisal which may be ordered by the senior participant at its option, when and if certain events, such as a loan default, take place.

When such an event occurs, the junior holder ceases to be the controlling holder. In a well-negotiated Participation Agreement, the junior participant would again become the controlling holder when the control appraisal event is no longer in effect.

Triggering events which lead to the senior participant's right to order an appraisal (and thereby potentially triggering a control appraisal event) should be limited in both number and scope. In any event, any cure period granted to the junior participant should have expired before the senior participant has the right to order an appraisal.

Typically, the senior participant would have the right to order an appraisal if: payments of principal or interest under the loan are delinquent for a specified period of time, customarily 90 days; the terms of the loan are materially modified, such as reducing the monthly debt service payment, reducing the interest rate or the principal balance or altering principal amortization; the bankruptcy or insolvency of the borrower or the appointment of a receiver for the mortgaged property; title to the mortgaged property has been acquired by the servicer on behalf of the participants; or the balloon payment is not made at the maturity of the loan.

A Participation Agreement could provide that the controlling holder has the right to dispute the appraisal and prepare a second one at the expense of the controlling holder, if it disagrees with the value of the property in the appraisal obtained by the senior participant. A second appraisal would often be controlling only if the second appraised value of the mortgaged property differs from that used in determining the control appraisal event by more than a certain percentage, often 10 percent. Alternatively, the senior participant may have the right to direct the appraisers to jointly appoint a third appraiser, at the expense of the controlling holder, to reconcile the differences between the appraised values determined under each appraisal, and the third appraiser's determination would be final and binding.

A junior participant can avoid a control appraisal by having the ability to provide cash security or a letter of credit in an amount that, when added to the appraised value of the mortgaged property, maintains the value of the junior participation at more than 25 percent of its original value. By doing this the junior participant avoids the control appraisal event and maintains its status as the controlling holder of the loan.

Decision Making

Where there is a controlling holder concept, the Participation Agreement will contain a laundry list of major decisions in connection with the loan, often numbering over 25 items, for which the controlling holder has the right to consent prior to the senior participant or, as is more typically the case, the servicer, taking any action. Obviously, from the standpoint of the junior participant, the more extensive the list, the more control the junior participant has over the loan. Rather than an exhaustive list of these major decisions, we will simply give a general idea of the types of decisions for which the controlling holder's consent is required:

(i) any modification or waiver of any of the monetary or other material provisions of the loan or the loan documents;

(ii) the exercise of remedies after an event of default, including any foreclosure on the collateral or equivalent action;

(iii) any sale, transfer, release or substitution of the collateral or any direct or indirect equity interests in the borrower;

(iv) permitting borrower to incur additional debt or the subordination of the mortgage;

(v) voting on a bankruptcy plan;

(vi) the termination or hiring of a property manager, hotel manager or franchisor;

(vii) the release of any guarantor;

(viii) the approval of a property budget; and

(ix) the approval of any major alterations or improvements at the mortgaged property.

Note that the senior participant or servicer could have the right to supercede the junior participant's major decision in the event of an emergency or if the decision was contrary to law or the servicing standard in the Participation Agreement. Also, the Participation Agreement could grant mere consultation rights to the controlling holder, without any real right to consent. A hybrid of this would be the obligation of the proposing senior participant to consult with the controlling holder, with a specified period, such as 30 days, within which to reach a decision. The failure to reach a decision within that time frame would be deemed approval of the proposed major decision.

Recent transactions have seen junior participation

purchasers being able to negotiate controlling holder language that not only permits the controlling holder to consent to certain material actions, and thereby block the senior participant or servicer from taking such actions, but also gives them the right to compel the servicer to take certain actions in specific situations. This new development is important for any junior participant and has broadened the rights of the controlling holder role in a positive way. For example, the junior participant may be able to negotiate language giving the controlling holder the right to compel the servicer to take action with respect to foreclosure on the collateral, sale of the collateral, termination and replacement of a property manager, the exercise of other remedies following an event of default and the settlement of insurance claims.

This ability to compel the senior participant or servicer helps to alleviate concerns over delays and lost opportunities which are inherent in the typical scenario where the senior participant or servicer must otherwise be relied upon to initiate various actions like the exercise of remedies.

The decision making standard in a Participation Agreement is dramatically different when a unanimous consent/major decision control standard is used. In these types of Participation Agreements there is still a controlling holder, but it may be in name only in that the controlling holder has limited rights by virtue of that role. This type of Participation Agreement is normally used in transactions where the senior participant has more leverage in the negotiations, such as where the loan is performing well and the junior participant's investment carries less risk.

The senior participant as the administrative agent is entitled to make the day-to-day decisions regarding the administration of the loan. Such decisions generally must be made in accordance with the standard of care set forth in the Participation Agreement and in any event in good faith and in compliance with all laws. A fiduciary duty is generally not implied unless explicitly stated in the Participation Agreement and the stated standard of care is a lesser standard. This is often defined as the higher of (a) the same care with which an institutional servicer services similar mortgage loans for third parties, and (b) the same care which the senior participant uses for loans for its own account, and with a view to maximizing the timely recovery of principal and interest, but without regard to the ownership of any interest in the loan by senior participant.

Having an appropriate servicing standard is critical to prevent the senior participant from making decisions regarding the loan which are beneficial to its participation interest but detrimental to the junior participations. Examples include modifying loan documents or delaying implementing a foreclosure or accepting a low foreclosure bid that would effectively wipe out the junior participations.

Even though the senior participant as the administrative agent has the right to administer the loan in such a structure, its powers to make certain decisions are limited, and these decisions are designated as either ''major decisions'' or ''unanimous decisions.'' All decisions which are ''major decisions'' typically require the consent of all junior participants as well as a majority of the senior class of participants. Such major decisions may include consent to a plan in bankruptcy, permitting a waiver or modification of insurance requirements, consenting to a release of reserve funds, modification of the terms of the loan documents, modification of the terms of the financial covenants of a guarantor or consenting to a modification or waiver of any of the provisions of a payment guaranty.

All decisions which are ''unanimous decisions,'' unless otherwise negotiated, require the unanimous consent of all participants. Such unanimous decisions include reduction in the principal amount or the interest rate of the loan, extension of any payment date under the loan, release of either the borrower or the guarantor with regard to any liability under the loan, release or subordination of any security for the loan, modification of the definition of event of default, disbursement of casualty or condemnation proceeds or consent to a sale or transfer of the loan collateral. All of these decisions generally require the consent of the junior participants except if a control appraisal event occurs.

Use of the unanimous decision/major decision standard weakens the rights of a junior participant—the most vulnerable participant—by permitting senior participants the right to hold up actions that serve the junior participant's interest, particularly in the case of a distressed loan, as the interests of the senior participants and junior participants may not be aligned. This standard also increases the possibility of deadlock among the various participants if the necessary consensus cannot be reached, particularly with respect to a non-performing loan, which will tend to increase the risk of all the participants. The reader is urged to look for a dispute resolving mechanism such as a ''buy-sell'' ensuring that action must be taken despite an impasse.

Rights in the Event of a Borrower Default

In the event that the borrower has defaulted on the loan, the junior participant should have certain rights under the Participation Agreement:

Cure Rights

One critical right is the right of a junior participant to cure any monetary or non-monetary default under the loan that the borrower has failed to cure within any applicable cure periods. Typically, the junior participant would have, in the case of a monetary default, an additional 5 business days and, in the case of a non-monetary default, an additional 30 days, to cure such default.

However, it may be possible to negotiate an additional period of time for non-monetary defaults which cannot be cured in such 30-day period or without taking control of the real property, or in the case of a mezzanine loan, the equity interests in the property owner. The Participation Agreement should be carefully reviewed to understand these cure rights, especially with respect to the bankruptcy of the borrower or any other ''incurable'' defaults. Another issue to check for is whether the cure rights continue after a control appraisal event occurs.

Each cure payment generally would include all unreimbursed advances and any interest charged thereon and any unpaid servicing fees with respect to the loan, but should exclude any default interest. However, interest would ideally only accrue on advances and costs during the period of time from the expiration of the grace period for such default until such cure is effected.

So long as any default is being cured by the junior participant, the senior participant and the servicer should be required to forebear from accelerating the loan, modifying or waiving any provisions of the loan documents, or commencing proceedings for foreclosure or other legal proceedings with respect to the mortgaged property. It is important to understand that the junior participant's right to cure monetary defaults and non-monetary defaults are often limited to a specific number over the life of the loan.

Enforcement Rights

A junior participant, in its role as the controlling holder, has the right to consent to most substantive decisions regarding administration of the loan and in certain situations has the right to compel the servicer to enforce certain remedies (as discussed with regards to the controlling holder). In a participation which does not use the traditional role of a controlling holder, the junior participant's hands are tied with respect to the enforcement of remedies under the loan documents and it must rely on the senior participant and the servicer to act prudently, in good faith and in accordance with any standard of care set forth in the Participation Agreement and any servicing agreement.

As the junior participant has no debtor-creditor relationship with the borrower, it is critical to negotiate enforcement rights with the senior participant. These include the right of the junior participant to compel the senior participant or servicer to commence and prosecute a foreclosure of the collateral for the loan, specifically the real property in the case of a mortgage loan, or the equity interests in the property owner in the case of a mezzanine loan. Also critical is the right of the junior participant to file, on behalf of the lending group, a claim in the bankruptcy of the borrower or any guarantor or any related party, if the senior participant or the servicer does not timely make such filling.

Prior to being negotiated, the standard Participation Agreement would instead provide that these rights belong exclusively to the senior participant, provided that the applicable servicing standard is being complied with.

Purchase Option

The most junior participant typically has the right to buy out the senior participant(s) at par in certain circumstances, typically limited to the occurrence of major events of default and/or the maturity date under the loan being accelerated, but such right can be extended to any monetary event of default under the loan, the borrower filing a petition for bankruptcy or the loan becoming a specially serviced mortgage loan (i.e., imminent risk of default).

If any of such triggering events occur, the senior participant is obligated to give notice to the junior participant and the junior participant typically has 10 business days to decide if it wants to purchase the senior participation. If so, the junior participant will have roughly 30 additional days to purchase the senior participation.

Keep in mind that while 30 days may not seem to be a very long period to come up with the funds to purchase a senior participation, in reality the junior participant has in most cases had ample warning that the loan was heading towards default and should have been preparing its strategy, including lining up the necessary funds to purchase the senior participation. However, in today's market these timeframes are open to negotiation. If there are additional junior participants in the loan, the Participation Agreement should state that the purchase option granted to the most junior participant is senior to any purchase option granted to any other participant.

One critical aspect of the typical purchase option provision is whether the purchase price payable by the junior participant includes prepayment or yield maintenance penalties, late charges or interest at a default rate. While the senior participant will negotiate harder for the inclusion of the prepayment or yield maintenance penalties, the junior participant should be in a better position to negotiate the exclusion of late charges and default interest from the purchase price. Note that the purchase option in some Participation Agreements may only be available before a control appraisal event occurs and is continuing.

Finally, in certain Participation Agreements the purchase option is set up as a ''buy-sell'', so that upon the junior participant electing to purchase the loan, the senior participant would then have the option either to sell its entire interest in the loan to the junior participant or purchase the entire interest of the junior participant in the loan.

End Game

Junior participants have several end-game strate-

gies available. The borrower could repay the loan upon maturity or prepay in accordance with the prepayment provisions of the loan documents. In a construction loan or a condominium conversion, the payoff can be relatively quick, as the loan may be taken out by a permanent loan upon completion of construction, or repaid in part or entirely upon the sale of condominium units. The purchaser must be careful to understand the projected timeframe on these types of loans and determine whether its investment is worthwhile. These loans, of course, also carry additional risk of nonpayment, especially in light of the current uncertainty in the credit markets and the anemic or even paralyzed condominium market in many areas of the United States.

In addition to the rights of the junior participant to purchase the loan upon certain borrower defaults, the junior participant will want the right to sell its interests to a third party. Most Participation Agreements significantly restrict the sale of a junior participation. It is often possible to negotiate the ability to transfer up to 49 percent of the loan to a credit worthy entity (for example, having assets of at least $500,000,000), so long as the junior participant retains management and decision making control of the junior participation and the senior participant is not required to deal with the transferee in any manner.

Transfers to affiliates of the original junior participant are also generally allowed. The consent of the senior participant would be required for any other transfer, except if the sale is to a ''Qualified Transferee.''[2]

The use of the Qualified Transferee standard significantly limits the universe of purchasers of a junior participation, restricting the ability of many of the real estate opportunity funds that have been created in the recent past to purchase interests in loans. The same provision is also likely to restrict further participation in the junior participation to a Qualified Transferee. A loan which has been securitized may also require that a no-downgrade letter be obtained from each rating agency involved in the securitization, leading to additional cost and delay.

These restrictions on transfer are a potential trap for a purchaser of a junior participation if the purchaser has investors at the outset, as they may not be large institutions that meet the requirements of a Qualified Transferee. Therefore, this provision must be reviewed carefully and any required consent to the purchaser's participants should be obtained early on in the purchase process and as a condition of the purchase.

Conclusion

The purpose of this article was to touch on Participation Agreements in general and give the reader an understanding of how to best maneuver in the current market. It is important for an investor that is looking to purchase a junior participation to follow through on due diligence both with respect to the collateral as well as the loan itself. Fortunately, current trends in the market allow an investor to negotiate a stronger and broader universe of representations and warranties to further minimize risk in its investment.

Only a year or so ago an investor purchasing a junior participation would likely have been faced with a ''take it or leave it'' position by a senior participant or other holder when negotiating a participation agreement. Participation Agreements were more or less boilerplate and the senior participants would balk at any negotiating by stating ''the rating agencies will not accept that change.'' Present day 2008, the tables have turned and it is the junior participants that are able to tell the senior participants to take it or leave it due to the twin factors of reduced liquidity in the market and the loan originators' need to get paper off of their books. It is also looking unlikely that existing mortgage loans that have not already been securitized will ever be securitized, so the rating agency argument is at this point moot.

It is a perilous yet opportune time for investors in junior participations to be active in the market. Although there is no clear data available, it seems that many opportunities exist in the participation market, especially since the potential to negotiate both the price of the participation interest and control of the decision making with respect to the loan have tipped in favor of the junior participants. This being the case, once pricing is fixed, it is important for these investors to be proactive and to push hard in negotiating their controlling holder/decision making rights with respect to the administration of the loan. A purchaser of a junior participation in the current market should be extracting a far better yield on its investment and significantly more control over the major decisions involving the underlying loan than a junior participant facing the same set of facts in 2007 and prior years.

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[1] The full FASB criteria are as follows: (i) senior participant has not provided a guarantee of repayment or other form of recourse to the junior participant, (ii) the transfer purports to be a sale of a beneficial interest in the loan asset, (iii) the participation agreement may not expire before the loan has fully performed, (iv) the participation agreement must state that in the event that the senior participant is also the servicer of the loan, that any monies, notes or other collateral it holds are held in a ''custodial capacity,'' (v) if the senior participant is acting as the servicer it should keep all monies from the loan in a separate account and make sure there is no commingling of the funds for any significant period of time, (vi) if the senior participant is acting as the servicer, it must pass through to the junior participant its *pro rata* share of proceeds from the borrower less only the servicing fee, (vii) the participation agreement must provide that the senior participant does not have the unfettered discretion with respect to all matters regarding the loan and the administration thereof and (viii) the participation agreement must state that any benefits from a senior participant setoff are passed through to the junior participant on a *pro rata* basis.

[2] A ''Qualified Transferee'' is typically an institutional financial entity, such as a bank, saving and loan association, investment bank, real estate opportunity fund, insurance company or pension fund or a ''qualified institutional buyer.'' In each case, the entity must be regularly engaged in the business of making or owning commercial loans or real estate investments and maintain equity of at least $200,000,000 and assets of at least $500,000,000. For an investment fund, there may be additional requirements that the fund manager must meet in order for the fund to be a Qualified Transferee.