MITIGATING PROBLEM LOAN RISKS IN THE COVID-19 ERA

A Presentation for the Hampton Roads Chapter of The Risk Management Association

THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

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AREAS TO BE DISCUSSED

- Know your obligors (borrower and guarantors/pledgors) and communicate regularly.
- Evaluate the enforceability of your loan documents.
- Evaluate your collateral and lien position.
- Are there third parties that you need to consider?
- Develop a plan and act early and aggressively.
- Determine whether there is a solution (upgrade the credit) or whether you need to get the credit out of the Bank – consider economic realities.
- Debtor games—bankruptcy, threats of lender liability claims, etc.

BE VIGILANT (TRUST BUT VERIFY)

> Know your Customer—Character Matters.

> Background checks.

> Information Disclosure Certificate.

> Who has authority to sign and who must authorize?

> Where is each entity formed?

> What are the <u>exact</u> names and <u>locations</u> of all obligors/pledgors?

> Lien searches on all obligors.

> Understand the business and its industry.

> Determine <u>all</u> assets used to generate revenue and take a lien on those assets.

> Evaluate management capabilities.

> Do key managers have ties to the business?

KNOW THE DEAL

> Drill down on the parties, business deal and assets when funding into an acquisition.
> Analyze all acquisition documents, including exhibits and schedules to any purchase agreement.
> Obtain lien searches on the target entity (or seller of assets).
> Do you understand your customer's business plan, how it generates revenue and key strengths and weaknesses?
> All collateral is not created equal—some assets hold value better than others (retail inventory and restaurant FFE are notoriously weak).
> Mini-perms often become "permanent" – be thoughtful.
> If the financing is just a tax play, then does it pass the "gut" check.

SEEK OUT THE RED FLAGS

- Google your obligors periodically and at every renewal or other milestone—it is fascinating what you may learn.
- Examine financial reports and tax returns on a regular basis.
- Observe the borrower’s internal operations.
- Visit company offices and collateral locations periodically.
- Respond to your customers – they are stressed.
- Understand the economic forces affecting the industry.
- Validate projections and underlying assumptions.
- Evaluate the likelihood of a financial covenant being tripped due to current economic circumstances—would it make sense to proactively waive or modify covenants to avoid a default?

EARLY IDENTIFICATION IS CRITICAL

> Act early or you lose the race.
> The quicker both lender and borrower react to problems, the more options that are available.
> Give consideration to proposals and requests from your customers.
> Determine whether a credit can be restructured and the company can successfully implement a turnaround (key factors include more capital, change in management, new business strategy, possibly hire new management or turnaround professionals, etc.).
> Prompt reaction allows the lender to re-underwrite the credit with the benefit of hindsight.
> Positive cash flow is key (profits and losses are less relevant).

INITIAL STEPS—SCRUB THE FILE

- Perform an objective review of the loan documents, credit file, loan officer's desk file and all lien filings, perfection and priority.
- Identify any defects in documentation or lien perfection and correct those as needed – keep in mind the bankruptcy voidable preference exposure in connection with fixing problems.
- Look for any internal memoranda, emails or other communications that could create lender liability claims – *remember that essentially all email and other data on a computer can be recovered by forensic experts and is fully discoverable in litigation.*
- The loan officer's desk file (computer, I-Pad, etc.) often contains ammunition that can be used against the lender.

ANALYZE THE LOAN DOCUMENTS

- Does the lender have fully signed versions of each document (with all schedules/exhibits), legal opinion, title insurance policy, etc.?
- Have there been any verbal agreements or courses of conduct that would be a basis for an implied waiver of any document terms?
- Did the right person, with proper authority, sign each document? Do you have the fully signed resolutions in addition to the Bank’s certified resolutions (<u>these are not the same thing</u>)?
- What are the possible defaults under the loan documents?
- What are the notice, cure and waiver requirements, if any?
- Are there any cross default or cross collateralization terms?
- Is any other party (participation agmt or subordination/intercreditor agmt??) entitled to notice of or to consent to your proposed course of action?
- Is there any exposure to another creditor or third party?

EVALUATE THE COLLATERAL

- Get current valuations and match those to asset values on the customer's balance sheet.
- Get a FMV and a liquidation value.
- What is the condition of the collateral?
- Is the collateral fully insured?
- Is the collateral accessible to the Bank?
- Do the security documents properly describe the collateral, and do you have first priority enforceable liens?
- Current lien searches are needed to discover things like federal tax liens, unpaid real estate taxes, mechanic's liens, judgment liens and other encumbrances against the collateral, <u>and to verify your lien priority.</u>
- If FF&E is in a leased location, do you have a landlord's lien waiver?
- If any liens are perfected by control (deposit or securities accounts) then evaluate whether to exercise your control over those assets.
- Should you set off against deposit accounts in your Bank?

CONNECT ALL FINANCIAL DOTS

> Get current financial reporting and tax returns from all obligors, including using a detailed financial affidavit signed under oath.

> Evaluate cash flow, LTV and asset values – get new appraisals as needed.

> Are collateral values more or less than the secured debt?

> What will a distressed sale or liquidation (versus turnaround or wind-down) do to collateral values?

> Match up tax returns with financial reports -- understand any discrepancies.

> Is there sufficient working capital to fund a workout/turnaround?

> Do guarantors have the ability to inject cash or provide additional collateral?

> Do not overlook obligors' income tax refunds as sources of collateral or repayment—NOLs (carried back or forward) can generate refunds and create opportunities to file amended tax returns.

DO NOT OVERREACT

- Generally, exposure at the outset is limited to amounts outstanding plus incremental costs to restructure or recover the loan – don't make it worse (avoid the CLM).
- Evaluate likelihood that the obligors will "bob and weave" or use lender liability allegations as a shield.
- Do not react emotionally – always be fair, dispassionate and objective.
- Do not communicate, <u>whether internally or with the obligors</u>, using sarcasm, profanity or language that belittles the obligors—always be professional.

COMMUNICATE CLEARLY AND OFTEN

- Open lines of communication – stay in touch.
- Be clear and forthright at all times.
- Talk to other stakeholders (equity holders, guarantors, pledgors, other creditors, etc.) as needed.
- Document all communications—think defensively and remember you do not want your communications to be evidence in a lender liability claim against the Bank.
- Always have 2 or more from Bank at meetings.

FORMAL STEPS

> Default and reservation of rights letter—the place to start.

> Default, acceleration and demand letter.

> Prenegotiation letter agreement—get one signed before meeting with obligors.

> Forbearance Agreement.

> All formal notices should be given in compliance with the notice provisions of your loan documents.

> All formal notices should be issued by the lender (not by counsel for the lender).

SOLUTIONS VERSUS COLLECTIONS

- > Is there a viable core business?
- > Evaluate the products and services—is there a market?
- > Evaluate management – is it willing or able to change?
- > Evaluate the industry and relevant market forces.
- > Does the company have sufficient working capital?
- > Can the business maintain positive cash flow?
- > Is there a credibility issue with the Bank, creditors, vendors or customers?
- > Consider whether the bank can readily sell the collateral.
- > Are partial or deferred payments better than no payments?

TYPICAL APPROACHES TO CONSIDER

- > Refinance.
- > Workout/forbearance.
- > The CARES Act and Interagency guidance give banks flexibility to provide COVID-related loan modifications/deferrals without triggering a TDR.
- > Restructuring/turnaround.
- > Liquidation of collateral.
- > Wind-down.
- > Options for the Non-Cooperative Borrower.

DEBTOR GAMES—HOW CAN YOU PLAY OFFENSE?

- Bankruptcy—Do not bury your head in fear.
- Bankruptcy gives a secured creditor a framework for a workout or liquidation and free discovery.
- Penalties of perjury get obligor's attention.
- Secured creditor gets paid 100% before any other constituent gets paid—The Absolute Priority Rule.
- Be sure you know whether there is any lender-liability risk.
- Adequate due diligence at the outset of the case positions the lender to deal with debtor strategies successfully.
- Pre-petition involvement with restructuring planning can be powerful.

CREDITOR GAMES—PLAYING DEFENSE

> Automatic stay considerations.
> Payment History Assessments—90 day look back.
> Look at the Debtor's schedules and statements.
> Are there non-debtor guarantors that can be pursued?
> Is there non-debtor collateral that can be pursued?

WHAT STEPS CAN BE TAKEN IN BANKRUPTCY?

> Can you serve on the Committee?
> Determine what caused the filing.
> Engage counsel.
> New Subchapter V considerations.
> CARES Act considerations.

KEYS TO SUCCESS

- Understand the facts and develop your strategy promptly.
- Aggressively pursue your strategy – if there is negative cash flow then you need to accelerate your involvement to prevent waste of your collateral position.
- If you give waivers, modifications or restructure the credit, then get value in return (additional collateral, equity infusion, increased pricing, fees, etc).
- Do not threaten action you are not prepared to take—mean it when you draw a line in the dirt.
- Do not make unrealistic demands or set unachievable deadlines.
- Forbearance is often the preferred approach to a workout—keep them on a short leash.

QUESTIONS

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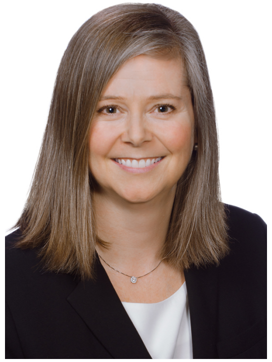

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