

# When a Borrower Is in Trouble

## situation

A borrower has begun submitting late payments on a commercial loan. Bank management wants to limit its exposure to a possible loss without confronting the borrower.

## in-house counsel challenge

Counsel must examine the borrower's financial situation and alert management to other signs of financial duress. Further, counsel must take pre-emptive steps to limit the bank's risk exposure should a bankruptcy occur.

## approach adopted

Familiarize yourself with the borrower's industry. How is the downturn impacting them and their customers?

**Look for other warning signs.** Loan covenants often require the borrower to provide financial information. Have suppliers moved them to COD? If you are the depository bank, are you getting hit with judgments or levies? Examine receivables too. Are they fudging the trade debt numbers? Is last-month's 30-day payment still listed as 30 days, rather than 60 or more? Are disputes with account debtors increasing?

If, for example, the borrower is a car dealer, are motor vehicle department fees and extended-warranty premiums being paid on time? When a vehicle is sold, the inventory loan for that vehicle must generally be paid within days. Visit the lot and "count the metal." Be sure the inventory matches the number on the loan.

Was there a sudden change in bookkeepers, or are there embezzlement allegations to explain payment delays? Are there missing withholding tax payments, sudden checking account overdrafts, requests for over-advances on lines of credit? Individually, there may be nothing seriously wrong. Combined, these are red flags.

Is management taking a severely reduced salary or taking out loans in lieu of salary to avoid paying withholding tax? Have they suddenly hired a law firm known for its bankruptcy expertise and/or moved their cash to another bank? A bankruptcy attorney will typically advise the borrower to move the cash to make it harder for the depository bank to exercise its right of setoff.

**At the same time, review the loan documents for flaws and correct them immediately.** If there is a lien on equipment, be sure the security agreement is properly completed and executed and the financing statement is filed in the appropriate jurisdiction. Otherwise, a bankruptcy trustee will seek to void your lien and classify you as an unsecured creditor. If you have documentation flaws, you may want to consider a forbearance agreement to fix them and get outside the preference period in bankruptcy. Forbearance agreements may also be appropriate by modifying the payment terms to get a borrower through a temporary rough spot. It is also a good time to improve your collateral position if possible.

## implementation steps

### Look for warning signs:

- Check payables for new COD requirements and receivables for late payments and payment disputes.
- Look for missing tax payments, unfilled tax returns and sudden checking account overdrafts.
- Is management taking a severely reduced salary? Have they switched law firms and moved their cash to a new bank?

### At the same time, protect yourself:

- Review loan documents for flaws and correct them immediately.
- Work with an appraiser or auction house to establish the loan collateral's worth and prepare strategies for a possible bankruptcy or secured creditor sale.
- Consider a forbearance agreement to correct document flaws or help the borrower get back on track, or refinance or sell the collateral.

**Review the collateral.** If it's commercial real estate and it goes to auction, what will you have to bid to protect your asset? Real estate appraisers are extremely busy right now. Consider a back-up valuation from a reputable real estate auction house that's experienced in your market and knows the property values at well-advertised auctions. They are often "in the trenches" on a daily basis. Should you need to, consider hiring them. It will increase your front-end costs, but professionals usually attract more qualified buyers to a sale.

## measuring success

Helping the borrower through a rough spot is the ultimate success. Otherwise, success is defined as heeding the warning signs and taking every possible step to minimize the bank's financial loss.



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