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Commercial Lenders: *Are You Ready For This Troubled Economic Time?*

By: Kelly W. McNulty

Every lender has experienced that scenario where they get notice that one of their loans is in default and they begin preparing for a workout. Most lenders have also had that scenario turn into a nightmare once they discover that the financing statement that was intended to place a lien on the borrower's equipment was never filed. What is the next step? What if the borrower files bankruptcy? Are there other liens out there?

In a thriving economy, the severity of issues like these are lessened. Low default rates and healthy balance sheets tend to make loan documentation errors fade into the background. When the economy turns, however, these mistakes raise their ugly heads. During the Great Recession, and specifically for the 10 quarters following the third quarter of 2008, total commercial loans and leases fell by a total of $1.3 trillion—a 16.2% drop for their peak. During that same time period, there were approximately $412 billion in commercial real estate loan defaults. The commercial loan default rate ballooned from .3% to almost 6%.

Commercial lenders may now be facing an even more daunting challenge. JPMorgan Chase recently estimated that the U.S. economy could shrink by 14% between April and June 2020, the biggest contraction since World War II. More than three million people filed unemployment during the last ten days of March, a nearly tenfold increase from one week ago and the largest number ever recorded.

The recent economic downturn gives lenders the ability to revisit how they handle loan defaults and workouts. The immediate goal of a commercial lender during a tumultuous economic period is to ensure that its loan is properly documented and the collateral is secured, to establish an open line of communication with the borrower, and, in the event of a workout, to create documentation that will make the loan enforcement process cleaner, safer and more efficient. Below are a few ways lenders can accomplish these goals.

1. **Identify Problems and Issues**.

Once a loan goes into default, the first thing every banker should do is pull all loan documentation associated with the loan to ensure everything they thought was in the file is actually in the file. The lender should check that the promissory note, the mortgage, the security agreement, the assignment of rents, the guaranty and similar documents are all found, and make sure that all documents are signed and include all of the relevant information. An unsigned security agreement can turn a fully secured loan into a general unsecured claim. All loan documents should correctly note the loan number and have the correct borrower. We have all seen loan documents that have one name on the front, but the signature of another entity or person on the signature page.

If there are deficiencies, the lender should immediately determine exactly what actions are needed to shore up any issues. If the mortgage or UCC-1 financing statement were not recorded—have them recorded immediately. If the guaranty is not signed, contact the borrower and have them sign it (the use of a forbearance agreement will be discussed in more detail below). Are the inventory or equipment lists up-to-date? To complete most of these tasks, the lender will have to communicate with the borrower, and that presents an opportunity for the lender to become more intertwined with the borrower and his or her business.

2. **Be An Asset to Your Borrower**.

One of the main complaints most borrowers have is that they are not able to communicate openly and regularly with their lender. This communication issue is also prevalent for lenders when there is a default. Borrowers have a history of disappearing once the loan goes into default. Lenders can take a few simple steps to avoid this problem and to facilitate the workout process.

a. Set Up a Meeting. When was the last time you visited the borrower's business? Such a visit allows the lender to not only improve their relationship with the borrower, but it also allows the lender to view how the business is operating. Is the business properly staffed? Is there sufficient inventory? Is the building in good condition? If your main collateral is the business' equipment, can you locate the majority of the pieces of equipment on-site? Is that delivery truck the bank has a lien on still being used, and where is it located? Only by visiting the business and getting to know your borrower better can you answer these questions.

b. Arrange for Regular Updates. Most loan documents contain a provision that requires the borrower to provide the lender with regular updates on accounts' receivables, inventory and other similar information. Have you been using that? Do you have this most basic information in your file, or, as is common, is your most recent inventory list from when the loan was issued? While most borrowers may see this additional reporting requirement as a hassle, explain that the bank can only make decisions on refinancing or loan workouts if they have the most updated information. Arrange for the borrower to send you monthly (or more frequently if necessary) reports. If the borrower is not already preparing these reports, that may be a warning sign.

c. Use These Meetings and Information to Your Benefit. While most lenders are wary of getting too involved in their borrower's business, banks can use these client meetings and updated information to better understand the viability of the borrower. In these troubled economic times, banks want their borrowers to be as healthy as possible. Banks can use this information to assist the client in improving their areas of deficiency. Is their A/R constantly lagging more than 60 or 90 days? Are they under-insured or over-staffed? While always avoiding taking actual control of the business, lenders can help improve the health of their borrowers by providing guidance and assistance on basic business operations. Even if it is just "gentle prodding," a borrower that knows the bank is going to review its operations will most often work harder to ensure its business is running efficiently.

3. Forbearance Agreement

The Washington Post recently reported that the "economy has entered a deep recession that has echoes of the Great Depression in the way it has devastated so many businesses and consumers, triggering mass layoffs and threatening to set off a chain reaction of bankruptcies and financial losses for companies large and small." Unfortunately, regardless of your efforts to assist the borrower, there will be many loans that wind up in the special assets department.

A forbearance agreement is often the best weapon in a lender's arsenal when a loan goes into default. A forbearance agreement is an agreement whereby the borrower ratifies and reaffirms all of its financial and other obligations to the bank, agrees to certain payment obligations, and waives many of its defenses to an enforcement action, in exchange for the lender foregoing its enforcement rights. A forbearance agreement also helps your borrower by providing it a structured workout plan. Your forbearance agreement should, at a minimum, contain the following provisions.

a. Recital of Loan History. The beginning of any forbearance agreement should set forth all of the loan documents that have been executed by the borrower. This not only centralizes all of the relevant information on the loan, it also forces you as the lender to organize and assemble all of the loan documentation.

> WHEREAS, the Borrower executed and delivered to Lender that Promissory Note dated _____ in the original amount of $_____, and that Security Agreement dated _____filed of record in the Arkansas Secretary of State Office on _____ as Instrument No. _____, and that Mortgage dated _____and recorded in the Office of the Circuit Clerk and Ex-Officio Recorder for _____ County, Arkansas (the "Recorder's Office") on _____ as Instrument No. _____, and that Assignment of Leases and Rents dated _____ and recorded in the Recorder's Office on _____ as Instrument No. _____, and related security and loan documents related to Loan No. _____ (collectively, "Loan No. _____").

b. Reaffirmation. The borrower should ratify and reaffirm all of the loan documents, all of their signatures, and all of its obligations contained in the loan documents. For example:

> Borrower and Guarantor swear, affirm, attest, warrant and represent to Lender the following:

> That this Agreement constitutes and comprises a legal, valid and binding obligation that is fully and completely enforceable against Borrower and Guarantor.
>
> That Borrower and Guarantor hereby ratify and reaffirm all of their financial and other obligations of every nature that are set forth and contained in the Loan or New Loan Documents.

c. Forbearance Conditions. The forbearance agreement should fully and clearly set forth the new payment terms and other conditions placed upon the borrower. For instance, the agreement should state how much the new payments will be and when they are due. If any taxes are due, the agreement should require the borrower to pay them by a date certain. The bank can also get the borrower to agree to the reports and meetings encouraged above. The agreement should also require the borrower to pay the cost (*i.e.*, attorney's fees) for the forbearance agreement, and any other costs that may be incurred by the bank. Finally, to ensure that the borrower will assist in any additional modifications that may be necessary in the future, the agreement should have the following provision:

> Borrower shall perform such other actions as deemed reasonably necessary by Lender to accomplish the purposes of this Agreement.

d. Waiver. One of the main goals of a forbearance agreement is too ensure that the borrower does not possess any claims against the lender or defenses to the enforcement of the loan documents. To the extent any such claims or defenses exist, the forbearance agreement should contain language waiving them.

> Neither Borrower nor Guarantor possess any offset rights, counterclaim rights or other defenses to the payment and performance of their financial or other obligations that are set forth in the Loan, New Loan Documents or this Agreement but to the extent they may have such a claim or right, they fully waive and release them in their entirety.
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> Neither Borrower nor Guarantor possess any lender liability, duress, business or contractual interference or other claims of any nature against Lender, its predecessors in interest, successors or assigns, or its agents, but to the extent they may have any such claims, they fully and knowingly waive and release any such claims in their entirety.

e. Event of Default and Termination of Forbearance. The agreement should contain provisions similar to the following:

> All parties hereto acknowledge, understand and agree that Borrower's failure to pay when due any required payment due under the Loan and this Agreement or to pay or perform any other condition or covenant of any nature as contained in

this Agreement or the Loan or New Loan Documents, shall be considered an Event of Default without the need for any notice or any cure period, notwithstanding the existence of any notice or cure periods in the Loan or New Loan Documents, all of which are hereby waived ("Event of Default").

This Agreement shall terminate on _____, unless extended as provide for herein. All parties hereto acknowledge, understand and agree that should any Event of Default occur under this Agreement prior to _____, the Loan, or the New Loan Documents, then Lender's obligation to forbear collection and enforcement efforts shall immediately cease, and that the Lender shall have the right to promptly and immediately prosecute its claims against Borrower and Guarantor.

f. Consent Judgment. Although some courts will resist the enforcement of this provision, the forbearance agreement should provide that the "Lender shall be entitled as a matter of law and fact to a judgment against Borrower and Guarantor should Lender terminate its forbearance obligations under this Agreement."

There are many other provisions that can and should be added to the forbearance agreement to ensure that the lender is in the best possible position at this stage of the loan. You should contact a creditor's rights attorney at the first sign of borrower distress and he or she can assist you in preparing the necessary documents and making sure that you are ready for the worst.

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