Commercial Loan Workout Considerations For Lenders

By **Brian Memory and Jacob Sparks** (August 24, 2020)

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The adverse economic effects of the COVID-19 pandemic will impact the business activities of financial institutions and their customers for the foreseeable future.

As borrowers struggle with reduced cash flows, depreciated collateral values, supply chain disruptions, changes in consumer shopping behavior, and new health and safety practices that constrain capacity and productivity, lenders will likely continue to receive a higher volume of borrower requests for forbearances, loan modifications or other accommodations.

When dealing with distressed borrowers, financial institutions must pursue proactive measures to assist their borrowers in finding stability and financial success, to protect the interests of the institution, and to preserve the value of the institution's loan portfolio.

Document Analysis

Financial institutions should begin by collecting and reviewing all documents, including correspondence, relating to the loan. Documents should be preserved, well-organized and made easily accessible.

Lenders should confirm they have all required documentation and necessary signatures, and that the documents are otherwise free of errors or other deficiencies that could impact the financial institution's position. Workout situations provide an invaluable opportunity for the lender to resurrect missing documents, to cure document deficiencies, and to address drafting errors.

Lien Perfection and Priority

A lien perfection and priority analysis is a critical part of any loan file review. This is a great time for the lender to confirm it has a properly perfected lien on collateral and its perfected lien is first in priority among any other existing creditors. As the method of lien perfection differs based on the type of collateral at issue, the review and advice of counsel can be an invaluable resource in this endeavor.

Under the Uniform Commercial Code, lien perfection for many types of collateral requires the filing of a UCC financing statement.[1] This relatively simple task is nevertheless prone to errors. Factors to consider include the following:

Correct Party Name

The debtor's stated name must be the name on its most recent "public organic record" filed with or issued by the state in which the borrower was formed or organized.[2] For example, if the borrower is a Texas entity, a UCC financing statement must be filed with the Texas secretary of state, and the debtor's name on the UCC financing statement must be the borrower's name on the most recent filing with the Texas secretary of state that states, amends, or restates the borrower's name.[3]

Failure to provide the correct name of the debtor on a financing statement can make it "seriously misleading" under the UCC, rendering it ineffective to perfect a lender's security interest in the collateral.[4] Notably, in some transactions a lender may receive a pledge of certain collateral from a related party that is not technically the borrower. Any UCC financing statement filed to perfect an interest in that collateral must be filed under the name of the pledging party.

Correct Jurisdiction

A UCC financing statement filed in an incorrect jurisdiction does not perfect a security interest in the collateral described therein.[5] The UCC must be filed in the designated office of the state where the borrower is organized.[6] UCC financing statements, however, are frequently misfiled in the state where the debtor is operating its business, rather than in the state where it is organized.

Correct Collateral Description

Lenders should review collateral descriptions in security agreements and financing statements to ensure that collateral is properly identified. Both the security agreement and financing statement must describe the borrower's assets encumbered by the lender's security interest. Under the UCC, a financing statement is adequate only if it "indicates the collateral."[7] A collateral description is sufficient if it indicates it covers "all assets or all personal property,"[8] or if it "reasonably identifies what is described."[9]

To reasonably identify what is described, the financing statement must conform to the requirements applicable to collateral descriptions in security agreements. With respect to security agreements, the UCC contains a nonexclusive list of five specific ways to reasonably identify collateral,[10] plus an additional open-ended option: "any other method, if the identity of the collateral is objectively determinable."[11]

Preferential Transfer

There are many risks associated with security interests that are not properly perfected, not the least of which is avoidance of the security interest by a bankruptcy trustee.[12] If corrections to existing UCC financing statements are required, or if new filings are needed, it is critical that these actions occur more than 90 days before a borrower files bankruptcy. Otherwise, the lender may find itself on the receiving end of a proceeding in the bankruptcy court to avoid the transaction as a preferential "transfer of an interest of the debtor in property."[13]

Post-Closing Lien Searches

Many financial institutions obtain, or require their counsel to obtain, post-closing lien searches verifying that the UCC financing statement is now reflected in the public records. Financial institutions should be cautious in placing too much reliance on such search results, as illustrated in the following examples:

Example 1

Bank engaged Lawyer A to file a UCC financing statement on ABC, LLC, a Delaware limited liability company. Unfortunately, Lawyer A mistakenly filed the UCC-1 financing statement in Texas (state of operation), rather than in Delaware (state of organization).

If Bank also has Lawyer A provide a post-closing lien search, Lawyer A will likely conduct the search in the same state where she filed the financing statement, which would be incorrect. Bank now has a post-closing lien search for its file confirming that a UCC financing statement was, in fact, filed. Unfortunately, the filing and the search are incorrect and do nothing to perfect the Bank's interest in the collateral.

Example 2

Bank engaged Lawyer A to file a UCC financing statement on ABC, LLC, a Delaware limited liability company. Unfortunately, Lawyer A lists the debtor's name on the UCC financing statement as "ABC, LLC, a Delaware limited liability company," rather than as "ABC, LLC." This error — adding extraneous words that are not part of the debtor's name — would most likely be considered seriously misleading under the UCC and render the financing statement ineffective.

If Bank also has Lawyer A provide a post-closing lien search, she will likely use the same incorrect name to conduct the search, so the post-closing lien search will be worthless, except to potentially show other filings under the incorrect name. Unfortunately, Bank probably does not have a perfected security interest in the collateral.

Prenegotiation Agreements

Prior to engaging in workout discussions, financial institutions should consider entering into prenegotiation agreements with borrowers and guarantors in which, among other things, they acknowledge any existing defaults and agree that no oral or written statements will be binding on any party unless a formal written agreement approved by the financial institution is signed by all parties.

Please be aware that, in some instances, emails exchanged with borrowers can create legally binding agreements under state and federal laws governing electronic transactions.

The Uniform Electronic Transactions Act — adopted by 47 states, Washington, D.C., Puerto Rico and the Virgin Islands — treats electronic signatures the same as traditional ink signatures.

The UETA states that "[i]f a law requires a record to be in writing, an electronic record satisfies the law."[14] Also, "[i]f a law requires a signature, an electronic signature satisfies the law."[15] An "electronic signature" is "an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record."[16]

More specifically, an electronic signature is "attributable to a person if it was the act of the person,"[17] the effect of which can be determined from "the context and surrounding circumstances at the time of its creation, execution, or adoption, including the parties' agreement, if any, and otherwise as provided by law."[18]

Courts interpreting these provisions have found that an email can satisfy the legal requirement that a record be in writing and a signature line can constitute an electronic signature.

In light of the UETA and other state and federal laws governing electronic transactions, entering into prenegotiation agreements with borrowers and guarantors can help minimize a

lender's risk that a court will later find that an email constituted a binding agreement. For the same reason, lender representatives who dealt with the borrower, but are not part of the workout negotiations, should be identified and asked to refrain from communicating with the borrower.

Loan Workout Agreement Considerations

Workout agreements — whether a forbearance, modification, deferral or other similar agreement — create an opportunity for the financial institution to make the best of what might otherwise be an unfortunate situation for all parties. Financial institutions have a vested interest in helping borrowers obtain stability and achieve financial success, while protecting the interests of the financial institution.

Although there are a plethora of issues to consider and opportunities to achieve these goals, the following are highlighted for consideration:

Information Gathering

Lenders should use this opportunity to gather as much current data as possible. A field audit of current inventory, accounts receivable and equipment is prudent to obtain current valuations of collateral and to verify the accuracy of the borrower's reporting. The information gathering may also help the financial institution recognize strengths or weaknesses in the borrower, its management team or its industry.

Additional Collateral

The financial institution might feel more comfortable making certain accommodations to the borrower in exchange for additional collateral. When available, a lender can obtain liens on unencumbered assets, or second liens on encumbered assets. If the lender takes a lien on encumbered collateral, an intercreditor agreement with the other lienholder may be wise.

Pledge Agreement

If the borrower is a partnership or limited liability company, the lender should assess the desirability of requiring an equity interest pledge. Likewise, if the borrower is a corporation, the lender should consider requiring a stock pledge. In either situation, experienced counsel can help the lender perfect a security interest in the pledged collateral.

Landlord Waiver

If the lender does not already have a landlord waiver and subordination agreement (where applicable), or if the borrower has changed locations, the lender can require such an agreement from the borrower and its landlord. In light of the pandemic's impact on the commercial real estate market, anxious landlords likely will want to keep paying tenants, even if it means giving up statutory landlord lien rights.

Deposit Accounts

If the lender is not the bank with which the borrower's deposit account is maintained, the lender can obtain control of the borrower's deposit account through a deposit account control agreement.[19] If a default occurs later, the lender will then be able to instruct the borrower's bank to pay the balance of the borrower's deposit account to the lender.[20]

Conclusion

During challenging economic times, financial institutions need to work proactively with borrowers on commercial loan workouts that are in the best interest of both the institution and the borrower.

In doing so, lenders should take the opportunity to analyze loan documents, identify potential issues and strengthen the lender's position during the workout process. To the greatest extent possible, lenders should also use the workout process to obtain or to replace missing documents, cure document deficiencies, fix drafting errors, and obtain additional security.

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[1] UCC § 9-310(a).

[2] Id. § 9-503(a)(1); see also id. § 102(a)(68) ("public organic record" means, among other things, "a record consisting of the record initially filed with or issued by a State or the United States to form or organize an organization and any record filed with or issued by the State or the United States which amends or restates the initial record").

[3] Id.

[4] Id. § 9-506.

[5] See id. §§ 9-301, 9-501.

[6] See id.

[7] Id. § 9-502(a)(3).

[8] Id. § 9-504(2).

[9] Id. § 9-108(a).

[10] A description can reasonably identify collateral by (1) specific listing; (2) category; (3) with certain exceptions, a type of collateral defined in the Uniform Commercial Code; (4) quantity; or (5) computational or allocational formula or procedure. Id. §§ 9-108(b)(1)-(5).

[11] Id. § 9-108(b)(6).

[12] See 11 U.S.C. § 544.

[13] Id. § 547(b).

[14] UETA § 7(c).

[15] Id. § 7(d).

[16] Id. § 2(8)

[17] Id. § 9(a).

[18] Id. § 9(b).

[19] UCC § 9-104(a)(2).

[20] Id. § 9-607(a)(5).