

Wednesday, May 6, 2020

The COVID-19 Storm and Recession Aftermath

Storm Preparation: Batten Down the Loan Documents and Collateral

The Next Recession is Here

- Triggered by Covid-19 virus outbreak.
- Unemployment rate is very high and increasing daily. Could reach levels not seen since Franklin Roosevelt was President.
- Levels of household debt that we have not been seen since the financial crisis of 2007.
- Commercial loans in default and many businesses may not survive.
- Federal government has stepped in to blunt the impact but may not be enough.
- How quickly will we recover this time?

Take Immediate Steps to Prepare for the COVID-19 Storm

- Consider whether making additional advances on discretionary lines makes sense. Will you get repaid?
- Review loan documents to determine if language exists to deny advance requests on committed lines including construction loans where normal due diligence is not possible (on-site inspections).
- Make qualified PPP and emergency loans under CARES Act.
- Enter into carefully drafted payment deferral agreements.
- Develop a plan to exit worrisome credits from the bank when credit becomes available. Hope is not a strategy.
- Consider credits that will be hardest hit by the recession - restaurants, business(es) subject to supply chain disruption, etc.
- Make demand?
- Commence collection efforts? Consider options and risk/reward.
- Set off?
- Enter into forbearance agreement now or wait?

Examine Loan Portfolio: Issue Spotting

- History does not repeat itself, but it often rhymes. Those of us who worked out defaulted loans during the last recession learned a lot about what can go wrong. Those same issues will likely reappear during this but may not be exactly the same. We need to apply the lessons learned to the loans you are about to make and to the ones currently in your portfolio.
- Examine suspect loans for deficiencies that will make a workout more difficult or prove problematic in bankruptcy. Closely examine loan documents, collateral (perfection and priority), covenants and defaults.
- Examine your borrower's business, management and operations. Tighten up covenants that will better serve as a bellwether of impending problems. By the time the first missed monthly payment occurs, it may be too late to be able to right the ship and avoid liquidation.

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Examine Loan Portfolio: Issue Spotting

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- Remedy documentation and other deficiencies now by correcting loan documentation problems, collateral issues and the like. Corrections should be made now to start clock on preference and fraudulent conveyance attacks by other creditors or a trustee in the event of bankruptcy.
- Are default provisions in loan documents adequate to give the bank the ability to take action in connection with anticipated problems related to the recession e.g., LTV and ability to obtain updated appraisals at any time; material change in the borrower or its business or the bank deems itself insecure in its reasonable discretion.

Loan Documentation: Common Issues

Avoid Self-inflicted Injury – Look Before You Leap

Review problem loans now for deficiencies and correct before acceleration, or as part of a forbearance arrangement.

- Examples:
 - Incorrect or inconsistent use of name of debtor.
 - Unclear or inconsistent defaults in different loan documents. Demand obligation but enumeration of defaults.
 - Incorrect specification of obligations secured in collateral documents. Dragnet clauses for future obligations.
 - Use of Fannie Mae mortgages to secure a commercial debt. Provides rights inconsistent with commercial obligations making collection difficult.
 - Incorrect name of debtor on UCC filings/change of name (entity, individual, trust).
 - Filing UCCs in wrong jurisdiction/change of jurisdiction (conversion of entity).

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Loan Documentation: Common Issues

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- Examples (continued):
 - Description of collateral in UCC does not match description in Security Agreement.
 - Incorrect description of real estate in mortgage (does not match description in title policy). Compare legal description to survey and obtain all necessary endorsements to your title insurance company. (Gaps and gores).
 - Mortgage does not contain a Power of Sale, not on statutory conditions.
 - Notary Provisions.
 - Guaranties – must be properly drafted to include provisions reflecting surety law and decades of case law.
 - Clear rights of setoff at any time, not just after default.

Perfection & Priority Issues: Personal Property

- Unique collateral requires unique method of perfection and some perfection methods beat others – A UCC-1 does not cover all types of personal property.
- Items of collateral requiring special perfection methods:
 - Deposit accounts (control).
 - Titled vehicles and yellow metal.
 - Patents and trademarks (ability to sell company as a going concern).
 - Liquor licenses.
 - Taxi Medallions (some lenders might still be lending).
 - Stock in a corporation.
 - Investment accounts.
 - Membership interests in a limited liability company (Article 8).
 - Tort claims.

Perfection & Priority Issues: Real Estate

- Committed vs. discretionary advances (multiple draws/tranches, revolving, construction, etc.). Discretionary advances are subject to intervening liens. Title rundowns and endorsements needed in connection with each advance.
- Hotel receipts. Treated as accounts under the Uniform Commercial Code, not rents under a Collateral Assignment of Rents recorded at the registry of deeds.
- MLC's and sale of real estate tax liens by municipalities. Good reason why your borrower should have owner's title insurance.
- Condominium liens.
- Mechanic's liens (filed and inchoate). Obligation to fund if certain conditions are met.
- Railroad rights of way and rights of first refusal in favor of Commonwealth – not covered by title insurance.

Construction Loans

- Some of the most problematic loans to have if a downturn occurs. What will the status of your project be when the music stops? Incomplete infrastructure and empty units?
- Michael Lewis – *Boomerang*. A pile of money on the table and no one is looking. What would a developer do – especially if he/she has several projects going at the same time?
- Unique loans with unique issues: Risk is front loaded. No cash flow, significant funds advanced before a sellable asset is produced. Repayment depends on completion of project, no significant construction defects, and sale or rental of units. If economic downturn occurs before full repayment, degree of problems depends on stage of project when downturn occurs.
- Lien issues: Priority (future advance issue and intervening liens), mechanics liens (general contractor and subs).

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Construction Loans (*cont'd*)

- Bonds: Lending to a contractor when insurer has to pay on a bond. Bonding company has priority lien on the receivables of the contractor even if the bank has a perfected UCC-1 financing statement.
- Examination of budget, permits, plans and contracts.
- Loan documents must contain specific procedures and conditions governing advances. Do not deviate or borrower might place blame on bank if things go wrong.
- Title rundowns, endorsements, lien waivers (from general and subs). Bellwether and protection.
- Follow the money closely and monitor construction- otherwise think of *Boomerang*.
- Consider joint checks – borrower and contractor.

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Construction Loans (*cont'd*)

- Experienced bank construction inspector is of paramount importance. Best ones are former contractors – they know all of the tricks. Avoid using loan officer to verify that work was completed and constructed correctly.
- Examine relationship between owner and contractor: Are they truly independent or can they be considered partners in which case the sins of one could be attributed to the other?
- Condominium issues
 - Mortgage on land and building or only on development rights? Foreclosing on development rights much different than foreclosing on land and buildings. Make sure title policy insures the right collateral.
 - Mass Law making foreclosing mortgagee liable for incomplete development. M.G.L. Ch. 183A, Section 22: “In the event of a foreclosure upon a condominium development, the lender taking over a project shall succeed to any obligations the developer has with the unit owners and to the tenants, except that the developers shall remain liable for any misrepresentation already made and for warranties on work done prior to the transfer.”
- Bankruptcy issues: Who (owner, contractor, sub); trust theories, post petition liens; preferential transfers, avoidance actions, assumption or rejection of contracts.

Setoff Rights

- The loan documents must permit setoff or the loan itself must be due at the time the setoff is made.
- Documentation must clearly provide that setoff is permitted at any time at the bank's option. Borrowers typically try to negotiate language that will limit the bank's right of setoff. Resist modifying the language. Limiting the bank's rights harms the bank and the borrower. Unsecured creditors might trustee process funds in the borrower's account to satisfy unsecured claims. If the bank exercises setoff when trustee process is received, the bank's loan will be paid down, and any guarantor's liability to the bank will be reduced.
- Once setoff occurs, written notice must immediately be sent by certified mail to the borrower.

Affiliate Relationship (Propco & Opco)

- Identify which entity owns the assets and properly perfect against each. Real estate is easy, but who owns the plant equipment, etc.?
- Loans to each should be cross defaulted.
- Lease between Propco and Opco.
- SNDA vs. SA: Most of the time an SNDA is appropriate if the lease is between unrelated parties and rent is at market. An SNDA is not appropriate where the bank has loans to both Propco and Opco. If a default occurs and both loans are accelerated, the purchaser at a foreclosure auction may not be able to purchase the property free of Opco and its lease (which could be under market) since the bank agreed not to disturb the tenant as long as its is performing under the lease.
- Ability to access collateral. Can the tenant prohibit you from entering the property to retrieve collateral? Avoid having to go to court by having good documents.



Questions?

The information within this presentation may not account for all specifics of your particular situation. It is not confidential legal advice and does not create an attorney-client relationship. Responsive inquiries are also not confidential and do not create an attorney-client relationship. You should always consult a legal professional to determine how the law may apply in your specific circumstances. We welcome the opportunity to discuss providing you with legal advice pursuant to a mutually agreeable written retainer agreement.

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