

Creditors' Rights LEGAL ALERT

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Signs Of A Troubled Loan—Keys To Early Detection

Early detection of loan problems is one of the keys to avoiding or minimizing losses. Early detection can often pave the way for steps that will minimize the loss or even better, to bring the borrower back into compliance with his/her loan commitments.

Although troubled loans sometimes become apparent only after the borrower defaults on payments, watchfulness by the lender will frequently result in identification of troubled borrowers before a default occurs. Because borrowers are sometimes unwilling to admit their business is in trouble, the lender can bring a more objective insight if he or she sees the signs.

Warning Signs of a Troubled Loan

Because even sound businesses have down cycles, the presence of just one or two of these warning signs may not be significant. But watch out for loans where you see several of these signs. Depending on the nature of the loan, other warning signs may also be present.

- Cash flow problems--decline in cash flow or inability to pay interest or trade obligations timely
- Repeated or mounting overdrafts
- Decline in sales or gross margin
- Deteriorating operating income masked by income from extraordinary transactions--the borrower begins to sell assets, or discounts receivables in order to generate cash
- Increase in credit inquiries sent to the lender
- Disproportionate ratio of debt to income and equity
- Decrease in capital expenditures and increase or stretching of trade payables
- Failure to make tax payments
- Unexplained or sudden resignations of inside or outside directors or key officers
- Sale of "profitable" portions of the borrower's business
- Delay in issuance of financial statements
- Circular borrowings--non-seasonal new borrowing to pay trade debt
- Trade vendors requiring C.O.D. or new extensive letter of credit treatment for delivery of goods

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- Catastrophic losses which cannot be compensated for through operating profit such as uninsured casualty losses, significant theft or embezzlement, or environmental liability
- Failing industry--change in market demand, regulatory restrictions or prohibition, internet competition
- Problems with other creditors, including suits filed against borrower

A lender that suspects its borrower is in financial distress should consider the status of the collateral. Is it safe? Is it insured? Is the borrower maintaining it? Is it dropping in value due to market conditions? Is it all accounted for? Additional inspections of collateral, appraisals, insurance reviews and a review of the debtor's books and records may be in order. If the debtor is not protecting the property by paying insurance premiums, for example, the lender usually has the option to pay for insurance itself and add that expenditure to the borrower's debt. The loan documents normally allow for these kind of protective advances.

Once a problem loan is detected, the lender should proceed on two fronts--an examination of the current status of the loan and an analysis of the lender's options in dealing with the loan. On the first front, the lender should take a fresh look at the loan documents--including security agreements and perfection, tax and lien searches, outstanding letters of credit, etc.--as this may be the lender's last chance to fix any documentation or perfection problems.

The lender should determine whether any of these signs constitute a loan default by reviewing the definitions of the default-triggering events in the loan documents. These may include covenant defaults such as an adverse change in loan-to-value ratios, a drop in current assets, or an increase in payables beyond acceptable amounts. Default notices and an opportunity for the borrower

to cure may be required by your documents. Finally, you should examine the status of the collateral, and determine whether the likely value of the collateral is sufficient, if liquidated, to cover all of the obligations, whether the collateral is valuable, and whether the value of the collateral may be realized and kept without resort to bankruptcy.

On the second front, analyze not only your legal options, such as foreclosure, but also possible negotiated resolutions, such as a workout agreement providing for partial liquidation of assets, a deed in lieu of foreclosure, or obtaining additional collateral to enhance the lender's collateral position. You may want to consider turning over responsibility for the problem loan to specially trained or designated loan personnel--for example a "special assets" officer, or another person who can objectively assess the status of the loan and will not be constrained by a personal relationship with the borrower.

Workout specialists generally agree that the earlier a troubled loan is spotted and acted on, the more likely it is that the business will survive and the lender will be paid in full.

T. Randall Wright

Write Your Borrower Before the Debt Workout Meeting

Meeting with a borrower or guarantor to try to "work out" a problem debt is a common approach for creditors. To reduce risk and

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increase the power of a creditor's rights after a meeting, write a letter to the borrower or guarantor before the meeting.

If statutes or the loan documents require a notice of right to cure or mediation, the creditor should send the notice before a workout meeting. Otherwise, creditors who voluntarily meet to try to resolve a default may find themselves having to wait an unexpectedly long time for cure or mediation period after a failed workout meeting. The pre-meeting communication should state that defaults are not waived and that the creditor will not be deemed to have reached a "deal" with the obligor unless and until the creditor signs a written extension, forbearance or settlement agreement.

The letter may include some specific issues you wish to discuss at the meeting, as long as some catchall phrase is included for flexibility. Additionally, list items that the obligor should bring to the meeting—such as current financial statements, a plan for repayment, and cash flow projections. With optimal content and delivery, a pre-meeting communication is a valuable procedure for improving collections.

Thomas O. Ashby

What You Can Do When Your Customer Files Bankruptcy (Without Violating The Automatic Stay)

Once a loan customer files bankruptcy, the "automatic stay" bars you from many actions, including any attempt to collect the debt or take possession of your collateral. The automatic stay is part of the Bankruptcy Code that makes it illegal to take action against people or companies in bankruptcy, if that action relates to some pre-bankruptcy debt or obligation. The automatic stay lasts throughout the bankruptcy case, unless the court orders that it is no longer in effect (a "stay relief" order). But you can still take some steps to protect your loan and collateral. Every situation is different, but here are some things you should consider doing right away.

Review your loan documents, including security agreements and Uniform Commercial Code (UCC) financing statements. Check to see if the person or business entity is correctly named and if your collateral is properly perfected. To determine if an entity is correctly named, review the organizational documents (certificate of incorporation, articles of organization, etc.) and/or search the corporate records of the state where the organization is registered. To determine perfection, see if the collateral you claim is properly described in the documents and if the UCC financing statement is filed in the correct place.

UCC Search/Title Search. If the collateral is personal property, run a new UCC search on the individual (in his/her state of residence)

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or entity (in state where entity is registered or in the state where its chief executive office is located for non-registered entities) to determine your priority against other lenders. If the collateral is real estate, order a new title search to double check your priority and other liens filed against the property.

Collateral Inspection and Appraisal.

Decide whether you need to inspect the collateral or have it appraised or reappraised. The collateral secures your loan, therefore, you want to make sure you know its value. The value of the collateral will determine if your claim is over secured, wholly secured or partially secured. Have your attorney arrange the inspection through the borrower's attorney. During inspection, do not say or do anything that might seem like an attempt to collect your debt or take possession of the collateral.

Cash Collateral. In a bankruptcy, "cash collateral" is the cash in your borrower's hands that is proceeds of your collateral—for example, proceeds of receivables or of inventory. If you have a security interest in that money, the debtor or trustee is not permitted to use it unless you consent or the bankruptcy court orders it. Creditors with an interest in cash collateral should not consent to its use without asking for protection—such as replacement collateral, payments, or both.

Consider Filing a Motion for Relief from the Stay. With the help of your attorney, you can determine whether a motion for relief from the stay should be filed. Relief from the stay, if granted, gives you the right to enforce your debt against the debtor's collateral. Often, an early motion for relief is not granted, but it may result in early, court-approved adequate protection payments that can be applied to your debt.

Calendar the Proof of Claim Deadline.

Review the debtor's notice of bankruptcy case to see if there is a deadline to file a proof of claim. Unless the bankruptcy court specifically instructs you not to file a proof of claim, it is important to file one in every case.

Be advised, however, once a proof of claim is filed, you are consenting to the jurisdiction of the bankruptcy court—meaning you may be required to come to that court, even if it is in another state.

Always contact an attorney who is a bankruptcy specialist. He or she may have advice that is important to protecting your rights. The twists and turns of bankruptcy law make it important that you have an attorney who understands the process and has experience.

Stacey L. Hines

How to Conduct a Commercially Reasonable Sale of Your Collateral

After a debtor defaults and a secured creditor takes possession of the collateral, the secured creditor will usually want to sell the collateral and apply the proceeds to the debt. Note that this article deals with personal property collateral. Real property sale rules are governed by real estate foreclosure laws.

The Uniform Commercial Code provides that the sale of personal property must be conducted in a "commercially reasonable manner." A commercially reasonable sale can be a public sale—such as an auction—or a private sale, for example to an individual where there is no competitive bidding.

Consider the Best Way to Sell the Goods

Generally, it is a good idea to sell the collateral in the same manner that goods of that type

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would typically be sold. For example, used office or farm equipment and used automobiles are often sold at an auction, whereas crops are often sold privately to elevators. A private sale may also be appropriate for collateral that is less commonly sold on a public market—for example, specially manufactured goods. However, public or private sales can each be “commercially reasonable” if they are handled correctly. Some sale rules are different for consumer goods than they are for non-consumer goods, although the differences are sometimes slight. It is always a good idea to consult with an attorney before you sell, to make sure you have complied with all the rules.

Timeliness and Notice are Important

The sale should be held in a timely manner, depending on the type of collateral. For example, perishable items should be sold quickly to avoid undue spoilage. On the other hand, a secured creditor should not necessarily sell an expensive vehicle for a low price just to wrap up the sale quickly. Before a collateral sale, the secured creditor should send written notice to the debtor, guarantors, sureties, and other lien holders, usually at least ten days prior to the sale (unless of course the goods may spoil in the meantime). Ask your attorney about the parties that should be notified to comply with the law.

Advertising Can Be Critical to a Good Sale

Advertising goods for a collateral sale can be very important. Although not every sale needs to be advertised to make it commercially reasonable, courts pay close attention to the amount of advertising utilized by the secured creditor. Ads should be designed and published to attract potential purchasers or bidders. For common or fungible types of collateral, such as vehicles or office furnishings, advertising in a local newspaper and web site might be sufficient. For more valuable or uncommon collateral, a secured creditor may want to advertise in a larger geographical area.

Explanation Required for Sale of Consumer Goods

After the collateral sale of most consumer goods, the secured party must provide a written explanation of the resulting deficiency or surplus. The explanation should include the resulting surplus or deficiency, the calculation thereof, and the extent to which future expenses may affect the amount of the surplus or deficiency.

Consequences of an Inadequate Sale

If your sale does not meet one or more of the above requirements, it may not be commercially reasonable. This issue may manifest itself if the secured creditor sues the borrower for a deficiency or if the borrower initiates a lawsuit to contest the sale. If a court finds that a sale was not commercially reasonable, it has the power to deny a secured creditor the right to a deficiency judgment, or worse, the secured creditor could be ordered to compensate the debtor for the difference between the amount of the sale and the true market value. If a secured creditor fails to conduct a commercially reasonable sale of consumer goods, additional penalties may apply. Counseling with an experienced attorney before a collateral sale can help to ensure the effectiveness of the sale.

Ben M. Klocke

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