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Fixer Upper?

What the Proposed Regulatory Reforms May Look Like

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Lending Lessons Learned in Recessionary Times

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During stable and positive economic periods, things like "loan defaults" "foreclosures" and "workouts" seem to be rarely mentioned or discussed in lending circles. When the economy turns recessionary and we encounter high unemployment and mortgage rates, along with housing market drops, history has repeated itself, in many instances, by creating significant challenges to the commercial lending arena. The purpose of this article is to highlight in a very summary fashion, some of the lessons that appear to recur when recessionary times are encountered and should serve as a necessary reminder and warning to those underwriting, administering, or otherwise negotiating commercial loans.

1. "Control" Converts Lender to "Insider"

When times get tough, lenders attempt to influence their borrowers by various means, including, steering management to undertake the will of the lenders. The danger in exercising control over a borrower's operations or management can convert the status of a lender to an "insider" (a defined term under the Bankruptcy Code essentially meaning someone who has direct or indirect control over the debtor) and can extend a bankruptcy preference or avoidance period from ninety (90) days to one (1) year, thereby rendering any loan proceeds advanced during such period to become unsecured. In a workout setting, the lender should attempt to exercise only appropriate remedies and to avoid exerting control over the day to day management decisions that borrowers normally make without input from lenders. Lesson learned: "Don't force or compel a borrower to take actions against its own interests, especially when those actions are intended only for the lender's interests."

2. Mechanics Liens for Unpaid Contractors and Subcontractors

When builders and developers are squeezed during recessionary times, the "trickle-down" effect results in many contractors and subcontractors not being paid during the administration of a construction project. Mechanics' liens are powerful remedies in clouding titles and gaining superiority over mortgage liens in certain circumstances. Construction lenders need to keep a close watch on loan administration issues especially during recessionary times to insure that loan proceeds are disbursed to the proper parties and are not diverted to other projects, or for personal

gain. Mechanics' liens can quickly absorb all of the equity that a borrower might have in a project during a very short period of time. The use of title insurance, releases, and joint payment vouchers are typically used to safeguard the mechanics' liens imposition problem.

3. Closing Protection Letters

Closing Protection Letters are a vital tool and should be required no matter what the state of economy. They demonstrate their value in tough times because Closing Protection Letters provide lenders with comfort that there will not be a defalcation or non-instructed disbursement of loan funds, especially when third parties are making the disbursements.

4. Timely Satisfaction or Release of Mortgages

Most state statutes carry heavy civil penalties for the lender's failure to satisfy or release its mortgage liens when the same have either been partially paid or repaid in full. The monetary sanctions can be disastrous for failure to timely satisfy, usually within sixty (60) to ninety (90) days of the receipt of the payment and some jurisdictions can even impose criminal penalties.

5. Shut off Lines of Credit Properly

Refinance lenders should especially beware that lines of credit or home equity loans are one of the most dangerous financing tools because they allow a borrower, even after repayment to a zero balance, to make future advances if the line is not closed or frozen correctly. In many cases, the failure to close and satisfy a line of credit or home equity line mortgage has resulted in future advances being made to a borrower by the intended former credit line lender who still maintains a lien priority over the new credit lender.

6. Failure to Get Proper Payment Evidence of Insurance and Taxes

Taxes and insurance are two of the most vital compliance items in the mortgage arsenal. It is critical that lenders monitor status and make certain that taxes and insurance premiums are paid, otherwise, the risk to their collateral either in terms of value or lien priority will be diminished since taxes can prime mortgage liens positions and casualty losses can wipe out collateral security value.

7. Incorrect UCC Filings

Secured creditors should always double check debtor's names before filing, and compare them with the actual names set forth in the Secretary of State's database where the entity is domiciled. "Close Enough" in a filing name is no longer "Good Enough" under the UCC, and such mistakes can and do result in a lender being unsecured by failure to make a proper filing.

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8. Oral Modifications of Loans

Beware that oral modifications can be binding on lenders. Most state laws, to the extent that they require that modifications be in writing, have exceptions that allow unequivocal conduct with reasonable reliance to also create a binding modification. Oral modifications of loans and part performance thereof can even result in a release of a guarantor or obligor if a court were to find, based upon the facts, that oral modifications were made after the lending arrangement had been documented and resulted in reasonable reliance by the parties that a certain action would be taken. Don't Make Oral Modifications.

9. Purchase Money Mortgages

Many State laws provide special priority rules for purchase money financing that is extended by sellers or lenders. Usually, if a purchase money mortgage is recorded within five days of a competing mortgage, the purchase money mortgage will have priority over that competing mortgage, notwithstanding the five day delay. Subordinate liens and purchase money financing create a whole host of difficulties for lenders when foreclosures or workouts are looming on the horizon.

10. Property Transfers to Affiliates

Seemingly, innocent transfers of property for estate planning purposes can result in lenders losing their title insurance coverages. When an individual borrower requests a transfer to an affiliated new trust or other entity, a lender should insist that a title endorsement be prepared, which continues the coverage under the underlying title policy, brings the policy to a current date, and does not impute any knowledge of the transferors to the lender with respect to title matters.

11. Swap Agreements / Misunderstanding the Product

Interest rate hedging products or derivatives also know as "Swap Agreements" provide useful risk protection against fluctuations in interest rates. Usually, Swap Agreements are used to create an artificial fixed rate for an otherwise floating or variable rate loan. Because these are capital market products, and because the agreements themselves are complex and difficult to comprehend, many borrowers do not fully understand the implications and risks of either unwinding or breaking Swap Agreements. Lenders should be very careful to insure that borrowers, who may be unsophisticated, have a full explanation in clear terms as to how the Swap Agreements will work and their impact on the overall loan transaction.

Conclusion

The foregoing highlight just some of the pitfalls that can be encountered by lending during recessionary times. Many of the items in this article tend to repeat themselves during each recessionary cycle, and do not pose new or unusual risks. The problem is, that many lenders become complacent about administering their loans in a methodology that would avoid these problems. Do not fall victim to them. Make sure that these lending lessons are reviewed and evaluated on a regular basis and not learned the "hard" way.

For more detail or legal authority citations, please visit the Young Conaway Stargatt & Taylor, LLP website at www.ycst.com and click on the full text of these subjects by going to the listed article.

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