

A Basic Guide for Lenders in Reviewing Credit Portfolios in a Challenging Credit Environment – Understanding Your Obligors, Documents and Collateral

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Given the current uncertainties in the financial markets and resultant credit and business contractions, it is important that lenders perform periodic comprehensive legal reviews and audits of their existing credit portfolios. The reviews should be conducted and the results reviewed in order to determine, among other things, whether (1) the loan documents are accurate, complete and in compliance with applicable credit approvals, (2) the lender has been receiving and evaluating financial statements and covenant compliance certificates on a regularly scheduled basis, at the intervals specified in the loan documents, (3) the borrower is in compliance with all financial and other covenants and (4) the lender has perfected its security interest in the collateral, as defined in the credit approval. The failure to perform such reviews and regularly and systematically monitor borrower financial performance and collateral maintenance may lead to unwelcome surprises that impair the ability of the lender to implement stress case scenario repayment strategies, both before and after a payment default and especially in the event of a bankruptcy, or other insolvency filing. Reviews should also be conducted in connection with any contemplated amendments of the loan documents.

It is important for the lender to have an accurate picture of how the borrower (and any guarantor or related obligor) is performing financially, as well as a full understanding of the collateral package and the lender's security interests therein. In some cases, the lender may find, after a review of a credit portfolio, that regularly scheduled financial disclosures have been expressly or implicitly waived or extended, or that the financial information and compliance certificates received are incomplete, or are otherwise not in compliance with the terms of the loan documents. *This article describes the review process with a view towards establishing certain steps to be taken by the lender to identify issues that could potentially impair the enforcement by the lender of its rights under the loan documents.*

Basic Loan Document Review.

Each file review should include a complete review and basic analysis of all applicable loan documents, which should confirm that the lender has in its possession all original signed loan agreements, security agreements, notes, amendments, pledge agreements, assignments, guarantees, intercreditor

agreements, participation agreements, subordinated loan documents, bond indentures, trust agreements, shareholder recognition agreements, blocked account agreements, confidentiality agreements, mortgages and deeds of trust, construction loan agreements, leases, assignments of leases and rents, lien waivers and releases, landlord waivers, subordination and non-disturbance and attornment agreements, special collateral perfection documentation and UCC financing statements (which may not be signed by the debtor) as applicable.

An example of a documentation deficiency that might be identified by such a review is where the principal amount of the loan has been increased, the maturity date extended, or a forbearance, waiver or interest and accrual agreement entered into, without the written consent or reaffirmation of the guarantor. In some jurisdictions, depending upon the language of the guaranty, this may impair the ability of the lender to enforce the guaranty. Another example of a document deficiency that might be identified would be the failure of the lender to file a continuation of a UCC-1 financing statement before its expiration, resulting in a loss of lien perfection and priority.

There are other basic documentation deficiencies that may be discovered, including unsigned or undated documents, amendments that were not approved by the appropriate credit authority, missing documents, language errors and deficiencies with respect to collateral descriptions, lien and payment subordination, or default provisions or defective or inadequate landlord waivers and indemnities, any and all of which deficiencies may have a material adverse effect upon the ability of the lender to exercise its rights under the loan documents in a default situation and realize upon the collateral in which the lender believes it has a perfected security interest.

If the loan agreement provides for a fixed rate loan option tied to an interest rate swap or hedge, the provisions of the loan agreement with respect to the definition of the "secured obligations" should be carefully reviewed to determine whether the definition includes all of the liabilities of the borrower under any ISDA (International Swaps and Derivatives Association) Master Agreement, or similar agreement.

Collateral Review, Inventory and Audit.

Each review should include a complete inventory and identification of all collateral and related documents, including, to the extent applicable, equipment, fixtures, pledged accounts, lock box accounts, intellectual property rights (including patents and trademarks), appraisals, environmental site assessments, stock certificates and powers, warrants, title certificates, franchise and license agreements, title insurance policies and endorsements, ALTA/ACSM surveys, UCC insurance policies and other insurance policies naming lender as additional loss payee. A comprehensive review of all borrower and guarantor formation documents, resolutions and incumbency certificates and amendments should also be performed. The review should include updated UCC, tax, lien and judgment searches with respect to each borrower, obligor and guarantor, as well as updated title searches with respect to any real estate collateral in order to identify any additional liens on the collateral, including tax and judgment liens and any judgments against the borrower, obligor and guarantor, the existence of which liens and judgments may constitute events of default under the loan documents.

It should be noted that Article 9, Section 9-402(7) of the UCC provides that where a business organization debtor changes its name, identity or corporate structure so that a filed financing statement becomes seriously misleading, the filing is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless a new, or amended financing statement showing the debtors correct new name is filed before the expiration of that time. Accordingly, the review should determine whether all required amended financing statements have been filed on a timely basis.

The lender should also obtain updated collateral valuations to determine current value. These updated valuations may consist of anything from formal third party appraisals to informal desktop evaluations, depending upon the types of collateral and the size of the transaction. This updated information will enable the lender to determine the appropriate amount to bid at a UCC or foreclosure sale and will assist the lender in recognizing what its expected position and potential recovery will be in a bankruptcy proceeding.

If the loan involves real estate with existing or suspected environmental concerns, a prudent lender should protect itself by obtaining an updated environmental site assessment prior to taking possession or control. While CERCLA and certain other federal, state and local environmental laws may provide limited safe harbors for mortgage lenders who take title to real estate for a limited time period to realize on and sell collateral, other environmental laws may not provide such protection.

All legal opinions of borrower's and guarantor's counsel should be reviewed to ensure that such counsel has opined on all of the legal matters required by lender's credit approval, including as applicable, the good standing of the borrower and guarantor, the valid, binding and enforceable nature of the loan

documents and the lack of any legal impediment to the practical realization by lender of its interest in the collateral.

Legal Review and Analysis of Loan Documents.

To the extent warranted by the nature and size of the transaction or portfolio warrants it, the review should also include an analysis by counsel familiar with applicable laws relating to the enforceability of the provisions of the loan documents, possible lender liability defenses and the realization of proceeds of collateral. In Illinois, the Credit Agreements Act (815 ILCS 160/0.01 et seq) provides commercial lenders with a reasonable defense against lender liability claims by requiring that an agreement by a creditor to modify or amend an existing credit agreement, or to reschedule or extend installments under an existing credit agreement will not give rise to a claim unless the agreement is in writing, expresses an agreement or commitment to lend money or extend credit or delay or forbear repayment of money, sets forth the relevant terms and conditions and is signed by the creditor and debtor. With respect to prepayment premiums, the Seventh Circuit Court of Appeals held in *River East Plaza L.L.C. v. The Variable Life Annuity Co.*, 498 F.3d 718 (7th Cir. 2007) that an agreed upon "Treasury Flat" yield-maintenance provision (discounted to present value with no addition of "basis points") was reasonable in the context of a sophisticated commercial loan transaction and should not be subject to liquidated damages analysis. In other states, there may be issues relating to usury, or in the case of loans secured by mortgages on real estate, single action rule or antideficiency statute issues, which could impact on the lender's ability to realize on collateral other than the real estate, or to enforce a guaranty of the loan.

In addition, where there is a concern that the borrower or related obligors may be insolvent or contemplating the initiation of bankruptcy or insolvency proceedings, the scope of the review should include bankruptcy law relating to "adequate protection" of creditors and "reasonably equivalent value" in the context of fraudulent conveyance analysis, as well as Bankruptcy Code provisions with respect to voidable preferences, which may impact attempts at loan restructuring on or within ninety days prior to a bankruptcy filing by the borrower.

Certain types of credits may involve additional legal analysis. If the lender has agreed to a "second lien loan" on the lender's collateral, the review should extend to the provisions of the intercreditor agreement between the lender and the second lien lender to determine the relative leverage of the of the lender and second lien holder with respect to a myriad of issues. Specifically, the provisions relating to payment subordination, standstill, waiver by the second lien lender of the right to challenge the validity, enforceability and priority of the first lien or seek "adequate protection" in bankruptcy, consent to the lender's use of cash collateral in bankruptcy, consent to "DIP" (Debtor in Possession) refinancing by the lender, vote on a plan of reorganization in bankruptcy and consent to a Section 363 sale of the borrower as an ongoing business should be reviewed.

Similarly, when dealing with a syndicated credit agreement involving an agent and multiple lenders, the credit agreement provisions with respect to yield protection, prepayments and break funding coverage, rights of setoff by the lender, legal opinions to be rendered, indemnities of the agent and lenders, agency, amendments and waivers, voting rights, assignments and participations, confidentiality and “waterfall” collateral rights in default should be reviewed and evaluated in order to determine the lender’s rights and remedies under the loan agreement, whether acting as a member of the syndicate, or independently.

To the extent the collateral includes intellectual property, all licenses, franchise agreements, security agreements and franchisor consents to assignment should be carefully reviewed and an analysis of the effects of Section 9-408 of the Uniform Commercial Code should be conducted in order to determine what rights, if any, the lender may have to assign its interests as the holder of a perfected security interest in the license or franchise to a third party. Section 9-408 provides that a provision in an agreement that relates to a general intangible, including a license or franchise, which prohibits, restricts, or requires the consent to the assignment or transfer of, or creation, attachment, or perfection of a security interest in such general intangible is not effective to the extent that the term would impair the creation, attachment, or perfection of a security interest, or provides that the grant or perfection of the security interest may give rise to a default, or right of termination under the general intangible. Accordingly, even if the assignment of a license or franchise is prohibited in a license or franchise agreement, if the lender has a perfected security interest in such license or franchise, the lender will have a limited security interest in a bankruptcy or insolvency scenario. This limited

security interest could be of significant value in the event of a Section 363 sale of a franchisee borrower as an ongoing business, where a significant portion of the value of a franchisee borrower is usually attributable to its rights under the franchise agreement.

Conclusion.

It is likely, given the current financial climate, with borrowers encountering mounting financial difficulties resulting from a general lack of liquidity in contracting credit markets, that an increasing number of credits will be moved from the “on-going relationship” mode to the “work-out” mode. It is therefore of extreme importance that lenders conduct comprehensive reviews of their credit portfolios so that they can be proactive in the identification and enforcement of legal rights and remedies and effectively realize upon their collateral. In addition, if credits are restructured, it is important that lenders understand all of the legal issues presented by the existing loan documents and identify any documentary or collateral related deficiencies so that they can address those issues in the loan restructuring documentation, with a view towards strengthening their positions in any subsequent litigation or bankruptcy proceedings.

There is no better way for lenders to identify loan documentation and collateral related issues than by performing comprehensive reviews and audits of the loan documents and collateral files. If these identified deficiencies appear to be recurring and systemic, the lender should be able to address them by changing its credit compliance, portfolio management and documentation retention systems.

Larry Hermalyn has extensive experience in negotiating and drafting loan and security agreements, intercreditor agreements and related documentation for complex credit facilities for borrowers and franchisees in a range of industries. He also prepares syndicated credit agreements and advises senior management on loan structuring, securitization, and workouts, as well as bank regulatory issues, such as anti-money laundering and loan securitization compliance. Prior to joining Lowis & Gellen, he served as senior in-house counsel to several major financial institutions, including as Assistant General Counsel, as well as a partner in a well-respected Chicago area law-firm. Mr. Hermalyn is admitted to practice in Illinois and Pennsylvania and is a member of the Chicago Bar Association. He received his law degree from the Indiana University School of Law, Bloomington, where he was a member of the Indiana Law Journal and a recipient of the Rufus Magee Fellowship. He may be reached at: lhermalyn@lowis-gellen.com or 312-456-8777.

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