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Lenders beware! - by Mattera and Currier

March 13, 2020 - Financial Digest

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Although we are currently in the midst of the longest recovery in history, recent market events remind us that the economy is cyclical. Household debt is at a record high, while the saturated retail and restaurant sectors have been generating a number of high-profile Chapter 11 bankruptcies. The next recession is not a matter of if but when.

What can lenders do now to prepare? While credit markets are still robust, lenders should take the opportunity to identify underperforming loans or worrisome credits, and transition them to other financing sources. It will be too late once credit tightens and alternative financing becomes unavailable. Lenders should also examine existing loan documentation for deficiencies, and take the opportunity to correct them. Covenant defaults, forbearance, and workouts are great opportunities to revise and improve deficient loan documentation, collateral descriptions, perfection issues, and to address defaults. Be prepared and expect the unexpected. Beware of sectors vulnerable to market fluctuation, adverse trade regulation, and supply chain disruption. No one anticipated the coronavirus or the challenges it would create.

How can lenders avoid common pitfalls? Know the process to avoid losing your lien. Unusual collateral requires special perfection methods. For example, liquor licenses, hotel receipts, stock and membership interests, etc. Each category of collateral should have individual attention given to the often complex technical requirements necessary to create and preserve the lender’s interest.

Know that certain claims can supersede the lender’s position, including mechanic’s liens, tax claims, and condominium fees. Just because the lender started in first position on its mortgage or security interest is no guaranty that another party will not intervene.

What options should lenders be aware of? Lenders and borrowers have a variety of options available to resolve defaults, each with pros and cons:

• Forbearance: Consensual workouts avoid the need for court intervention or lengthy proceedings. Forbearance presents a prime opportunity to tighten terms, enhance the collateral pool, and impose additional reporting and oversight requirements on borrowers.

• Foreclosure and Collection: In and out-of-court proceedings are available to enforce lender rights, but both involve additional cost and delay. Borrowers may assert counterclaims against lenders, and collateral may not be sufficient to cover indebtedness.

• Receiverships, Assignments for the Benefit of Creditors, and State-Court Liquidation: Each involves liquidation of the entire company for the benefit of all creditors, not merely lenders. Although the lender generally has exclusive claims to collateral, deficiency claims share in the process with all creditors. This option is administratively expensive and can be prolonged.

• Bankruptcy: Provides borrowers with the broadest powers to alter lender rights.

What should lenders expect in the immediate future? The new Small Business Reorganization Act (SBRA) will likely lead to increased bankruptcy filings. The SBRA went into effect on February 19th, and creates a new Subchapter V to Chapter 11, expanding access to bankruptcy relief for small businesses. With a debt ceiling of approximately $2.75 million, small business owners can take advantage of the new subchapter’s streamlined procedures and powerful tools to achieve an effective reorganization.

Key changes in the SBRA:

• Debtors have the exclusive right to propose a plan, in contrast to traditional Chapter 11 provisions for a competing plan process.

• No creditors' committees are appointed, reducing administrative costs.

• Company owners may retain their interest in the company without committing substantial new value or other assets to the plan.

• A plan may be confirmed even over objections by all creditors so long as all projected disposable income is committed to the plan payments for a period of three to five years, which is similar to the streamlined Chapter 13 requirements for individual debtors.

Changes under the SBRA eliminate many of the prohibitive costs and roadblocks for traditional small business debtors. As a consequence, lenders should expect to see bankruptcy filings rise for their small business borrowers.

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