

M|J|B BANKING LAW TODAY

Reviewing and Responding to Distressed Borrower Financials in a COVID World

Borrowers are typically required to provide updated financials to their banks within 60-120 days of the end of each calendar year. Tax returns are also to be provided after they are filed. This makes the end of Q1 and the beginning of Q2 a critical time for assessing the financial stability of a borrower. And, that assessment becomes even more critical this year, given that 2020 was the year when COVID-19 hit and triggered a series of lockdowns and business closures.

Ordinarily, banks can get a reasonable indication of borrower financial stability on an ongoing basis simply by reviewing deposit account records. However, in today's environment of PPP loans and other grants and government payments, even that indicator can be skewed due to a temporary infusion of liquidity into deposit accounts. And, that indicator can be skewed even further based on the fact that many creditors have voluntarily delayed collection activity, or have temporarily been artificially prevented from undertaking such activity due to government restrictions (e.g. moratoriums on evictions and garnishments).

Putting it all together, it is a fair statement, by and large, to say that while banks probably have a general sense

of borrower financial health, they likely do not know (as the borrowers themselves also may not previously have known) just how good or bad things truly are until they review the borrower's 2020 financials.

ASSESSING THE SITUATION

When borrower financials and tax returns are presented to banks, it is very important for banks to conduct an analysis that is both critical and also a bit different than prior years. Specifically, banks should do the following in their financial assessment:

- Get a clear sense of how temporary government payments have played a role in the financials, and assume that these payments will not be available beyond 2021.
- Get a clear sense of current borrower defaults with other creditors and voluntary forbearances that have been granted by those creditors. For a cash basis borrower, the numbers may be skewed (or badly skewed) due to these factors.
- Request financial breakdowns by month, or at least by quarter. Due to COVID-19, there likely will have been wild financial fluctuations as 2020 progressed. In assessing current financial health, make sure to put less emphasis on pre-COVID number and numbers from months where the business was in lockdown.

- Understand that past financials may not be as good of an indicator of future financial performance as they would have been in past years. Many businesses have been fundamentally altered through changes in customer consumption patterns and preferences brought on by the pandemic (e.g., buffets, nightclubs, etc.).
- Assess whether the numbers are being artificially inflated through sales of equipment (and other assets that function as the bank's collateral) outside of the ordinary course of business. If the bank's non-inventory collateral is being liquidated without the proceeds being remitted to the bank, that is a major problem. And, the problem is exacerbated if the borrower attempts to use the proceeds from these inappropriate sales to present an artificially rosy financial position to their bank.
- Assess and inquire into whether the borrower has been obtaining additional financing (potentially further encumbering the bank's collateral in the process) in order to stay afloat. New indebtedness, and expenses paid with new indebtedness, have a habit of mysteriously failing to appear on borrower financials.
- Look for indications that the borrower has started using a secondary operating account, such as a sudden and unexpected decrease in the volume of transactions in the existing operating account. Opening new deposit accounts tends to be the number one indicator of borrower conversion and fraud.

RESPONDING TO FINANCIAL STRAIN AND IMPROPRIETIES.

After conducting an intensive review of borrower financials, banks need to make decisions on how to handle troubled credits. The following steps should typically be followed upon revelation of severe financial stress or improprieties with a borrower:

- Discuss this situation with the borrower. The financials themselves only tell part of the story. The borrower is able to provide a lot more

information about the state of the business that gives the numbers much better context. And, a refusal of the borrower to cooperate in these discussions, or apparent borrower dishonesty and evasiveness, speaks volumes as well.

- Consider an external refinance of marginal credits. The easiest path out of a troubled credit is through an external refinance with either another bank or an alternative financier.
- Discuss with your borrower the prospect of a voluntary liquidation. If things are truly bleak, the borrower may be very anxious to exit the business as quickly, and with as little personal liability, as possible. The parameters surrounding a voluntary liquidation should almost always be set forth in a written plan.
- Consider entering into a forbearance agreement with the borrower. A forbearance agreement is a great, all-purpose tool that can either give the borrower the time they need to effectuate their plans and goals, or else set the stage for a more efficient and effective liquidation process. Forbearance agreements can be accompanied by confessions of judgment, deeds in lieu of foreclosure, voluntary foreclosure agreements, stipulations for claim and delivery and stipulations for the appointment of a receiver, among other things.
- If all of the above steps fail, or are inappropriate, then banks should proceed with collection action. Aggressive collection action should almost always be taken immediately in the presence of borrower fraud, conversion or fraudulent transfer.
- It is important to realize that speed is critically important in dealing with distressed borrowers. If widescale collection action occurs in Q2-Q4 of 2021, as many experts expect, the faster the bank moves the more they will recover and the more efficient the process will go. Expect many borrowers to collapse, expect courts to become overwhelmed, and expect collateral values in distressed industries (e.g. restaurants) to plummet later in 2021 and into 2022.

-Matthew J. Bialick, Esq.

Protect Your Bank from the COVID-19 Economic Crisis with a Legal Process Overhaul

The current economic climate has exponentially increased the risk faced by banks. Flawed practices, procedures and loan documents that never resulted in harm in a good economy can result in huge losses in troubled times. The M|J|B Law Firm helps bank deal with these risks through a comprehensive legal audit/overhaul. The services offered in this regard include the following:

- Preparation of custom loan document templates and financial disclosure templates of all varieties.
- Development of a new loan policy that specifies processes and procedures to be used by loan officers in making, renewing, servicing and liquidating distressed loans.
- Legal audits on existing credits that includes an assessment of things such as:
 - Completeness of loan documentation.
 - Collateral perfection and potential competing liens that may have attached to the bank's collateral.
 - Movements of assets, funds and equipment to identify fraudulent transfers, conversion, and financial misrepresentations.
- Regulatory compliance audits.
- Liquidation/workout analysis, assistance and support.

For more information on any of the above services, contact Matthew Bialick at 952-239-3095 or matthew@mjbblawmn.com *[Advertising Material]*



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