SEVENTH ANNUAL CONFERENCE ISSUE

OCTOBER 2008
VOL. 6, NO. 9

abf journal

FOR THE COMMERCIAL FINANCE PROFESSIONAL | WWW.ABFJOURNAL.COM

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Don't Get Stung...
Challenging Economic Times Require Heightened Due Diligence to Avoid the Risk of Loss

BY JOSHUA HORN

Recent experiences have made it crystal clear that financial institutions, both large and small, must be more attentive to customer selection and management in order to avoid future problems. Simple techniques can help minimize the risk of a bad financial relationship and avoid problematic client conduct.

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In these challenging economic times, financial institutions must be more vigilant than ever before. If Bear Stearns and Lehman Brothers have taught us anything, every financial institution is at risk from a portfolio of bad loans. This recent experience has made it crystal clear that smaller finance companies must be even more attentive to customer selection and management in order to avoid future problems. Simple techniques can help minimize the risk of a bad financial relationship and avoid common pitfalls and problematic client conduct.

Initial Due Diligence

As a result of the fallout of the subprime loan market, the financial industry will undoubtedly strive to improve the client intake process by requiring, among other things, greater fact gathering from new borrowers. The best and most detail-oriented client intake process will do nothing if lenders employing it do not take a more discerning approach regarding who they want as clients. In this highly competitive industry and tight monetary supply, all too often the desire to close a transaction results in turning a sharper eye away from certain red flags of potential trouble.

One of the biggest pitfalls is what can be characterized as the free-agent client. This is the type of client who has worked with a number of different financial institutions over a short period of time before coming to you. Although it is not uncommon for a borrower to shop around for better terms, hopping from one potential lender to another over a short period of time may be indicative of a borrower who can never be satisfied or one that may have improper motives. Indeed, these may be clients that are shopping for less scrutinizing lenders so that they can literally "take the money and run." Such red-flag raising conduct is all the more reason for heightened due diligence.

Putting aside the "standard" due diligence documents that a borrower must complete as part of any transaction, the age of instant information has provided financial institutions with a plethora of resources to conduct additional due diligence through publicly available resources. All federal courts (including bankruptcy courts) and many state courts, for example, make information publicly available over the Internet. Alternatively, there are services that you can use that will assimilate this information into one report similar to what you can obtain about the corporate world from Dunn & Bradstreet™.

In either case, you can search by company or individual name to determine whether your potential borrower or its principals are or have been the subject of litigation or bankruptcy. These research tools generally come with relatively little to no real costs because, among other things, you do not need to hire anyone with an advanced degree to conduct such inquiries. The breadth of publicly available information is limited only by the imagination of the person conducting the search; the days of blind reliance on the representations of a borrower are no more. Opting against performing a simple public records inquiry only exposes you to a borrower who may have a checkered past.

The second pitfall involves a lender trying to shoehorn the client in to the lender's style of funding transactions. For example, if you typically perform traditional asset-based lending, it may be unwise to try to shoehorn a client who requires unconventional financing. The prudent approach to taking on a borrower whose financing ability varies from what you are best equipped to offer may be to turn that potential borrower away. If not, you may be faced with a borrower who ultimately cannot satisfy its obligations, only to then claim in litigation that you defrauded them into accepting your proposal instead of others more suited for the borrower's needs and ability to repay.

The third pitfall involves the financier that gives in to the potential borrower with unrealistic expectations. A potential borrower whose revenue flow can comfortably pay down a loan of $5 million and wants to borrow $15 million (where repayment would be an unrealistic stretch) is a potential disaster waiting to happen. Notwithstanding

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the best due diligence, this potential borrower has unrealistic expectations and is at substantial risk of default. The hope of increased revenue in difficult economic times to satisfy the larger loan may be pie in the sky. Although being a financier is not without risk and every portfolio should have some component of high-risk/high-reward transactions, having a portfolio over weighted in high-risk/high-return loans may ultimately require you to answer to your shareholders and self-regulatory organizations for a defaulting loan portfolio.

Whether or not a financial institution decides to take on one of the potential problem borrowers noted above, the best protection is enhanced due diligence to ensure the potential risk of loss is a risk worth the investment. The next section discusses a common sense approach to minimize risk after completing thorough due diligence. The two hallmarks of this approach are communication and documentation.

The Relationship After Initial Due Diligence

Many financial institutions have the good fortune of working with the same borrowers on multiple transactions and have a track record of open communications, particularly when things turn downward. Others have what can be characterized as a "once and done" relationship. Notwithstanding the nature of the relationship, the simplest way to avoid problems before and after closing is to have open and ongoing communication. This is rather self-evident in as much as financial institutions that do not communicate with their borrowers become institutions without any borrowers. But there is more to this approach; communication must be followed with documentation.

The most common omission occurs when a borrower calls to make a specific inquiry, but does not receive a prompt return call. Regardless of the message you must send in response to the inquiry, the key is to actually communicate the message. By failing to respond at all, a financial institution sends mixed signals and can make a rather innocent issue fester into a major problem. Similarly, an inappropriate response can, in many ways, be worse than no response at all. The simplest approach to take is to return all phone calls every day and to treat each client like you would want to be treated by your own lender/financier.

As important to the open line of communication is documenting that communication. The only way to explain the importance of documenting phone calls is with a short true story, albeit in a different factual context. Some years ago, a widow claimed in a lawsuit that her husband's financial advisor improperly allowed him to cash out a life insurance policy. The facts revealed that the husband wanted the cash to buy real estate in Florida. The advisor recommended against doing so until the husband cleared underwriting for a new policy, but the husband ignored this advice and cashed out the policy. Before completion of underwriting on the new policy, a bee stung the husband, and he subsequently died of anaphylaxis. Fortunately, the advisor had detailed contemporaneous notes of all of his communications with the husband, including the warning against cashing out the first policy before completion of underwriting on the second. Although this factual context is a bit unusual, the lesson is clear. The simple act of taking detailed notes ultimately insulated the financial institution from substantial liability.

It is also incumbent on financial institutions to follow up their oral communications with some form of written confirmation, particularly when things are turning for the worse. Notwithstanding the fact that your loan documents will be comprehensive (including an integration clause), the absence of some form of written confirmation may provide a defaulting borrower with an issue to leverage against you for new terms or in a lawsuit claiming that there was some purported misconduct at the loan formation or renegotiation. The absence of written follow-up will be the best friend of a litigious borrower looking for a way out because that entity can simply make one claim and you would have nothing to refute the allegation. A financial institution can simply recap, in writing, the oral communications to avoid any confusion about what was discussed. The time spent on such a simple follow-up communication will be money well spent and go a long way toward building a record for your own protection.

All of the techniques identified above may appear to be rather simple and self-evident. Nevertheless, they are effective tools to minimize the risk of loss and to better defend yourself in the event of a claim. It is critical to take the additional time needed for due diligence and open communication and substantial documentation because, in the end, your most marketable asset is your reputation; nothing is worth more time to protect than that. abfj

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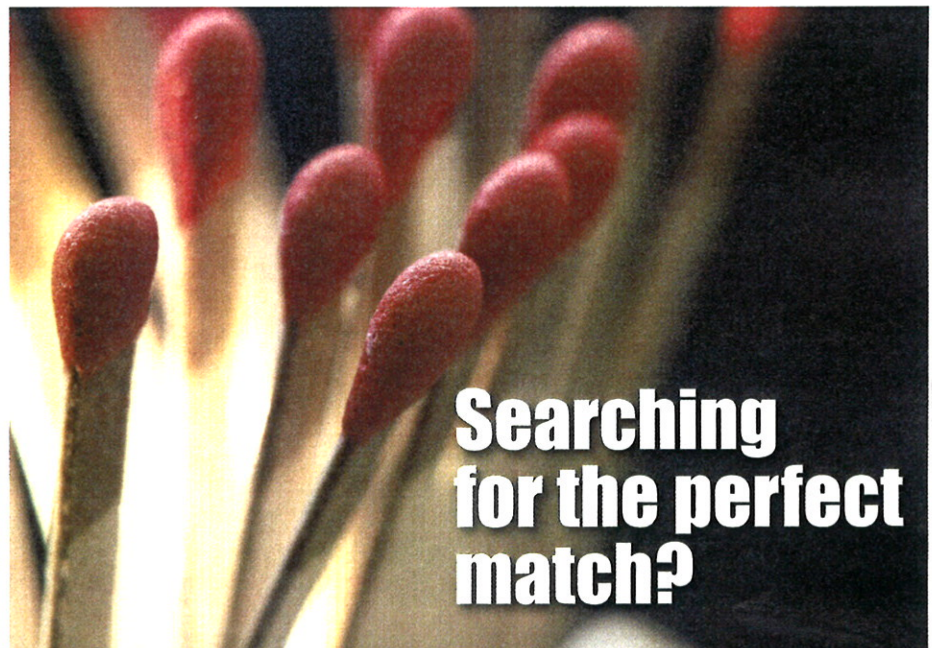

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