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Preparing for the Precipice: How Lenders May Best Protect Themselves from Future Borrower Defaults

Legal Update

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While economic forecasts may fluctuate like the winter weather of the Upper Midwest, as recently as mid-October 2022 some projections have 100 percent guaranteed the next U.S. recession in the next calendar year. With the total amount of outstanding commercial and industrial loans currently standing at over \$2.8 trillion in November 2022 (compared to \$1.57 trillion in November 2008), and outstanding consumer loans standing at \$4.7 trillion in October 2022 (compared to \$2.66 trillion in October 2008), it is clear that the U.S. lending industry may be facing a gargantuan credit default. However, as the innovator Alexander Graham Bell himself wisely stated, “[b]efore anything else, preparation is the key to success.” With such inspiration in mind, lenders still have time to prepare for these predicted trying times by taking certain proactive steps to protect themselves.

First, lenders should continuously gather information regarding their outstanding loans and borrowers for near-real-time updates on the risk of potential defaults by borrowers. Lenders should ensure that they continue to receive the periodic, current financial information that they are entitled to under their loan documents, including but not limited to financial statements from the borrower, personal financial statements from any guarantors, and reports or appraisals related to any collateral for the loan and any related guaranty. If necessary or desired, the lender should meet with the borrower or guarantor to discuss operations and financials and inspect any collateral to confirm that it has been maintained or determine whether additional or replacement collateral is necessary. If lenders or guarantors ignore or are hesitant to meet any such requests for information or inspection, an immediate red flag should appear for the lender prompting further action from the lender.

Second, after receiving their periodic financial documents from borrowers and guarantors, lenders should closely assess the data included. While easy to ignore or gloss over, this data is the main avenue for the lender to learn of any potential risks on their loan. It is therefore vital to take the time to review the financial information provided. Once reviewed, the lender should compare the data with the information communicated to it by the borrower or guarantor and any review of the collateral. If a discrepancy exists, the lender should follow up to determine what the cause is in the event of potential fraud or unknown factors causing financial uncertainty related to the loan.

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Third, if any telltale signs of a potential default or go-forward financial concerns are found from the information garnered from the lender's investigation of a borrower or guarantor's provided information, or if borrowers repeatedly and purposefully fail to provide that information, the lender must act as quickly as possible to protect its rights. If signs of potential distress exist, the lender should first and foremost confirm that it has properly filed all necessary paperwork for any collateral securing its loan, including proper financing statements. If not filed or improperly filed, the lender could find itself in the back of the line to recover from a delinquent borrower. If no formal default has occurred under a loan, the lender could place the loan on a watch list for potential default, after which it should regularly request further financial information from the borrower and any guarantors to update its plan of action as needed. If necessary, the lender may restructure or amend its loan as needed to address a borrower's changing situation and to further protect its interests, including the altering of payment schedules, total amounts to be paid, or further collateral or guaranties in its favor. Finally, if a loan is in default and no amount of amendments to the loan documents could help, the lender should consult with legal counsel and take any and all necessary collections actions, including formal demands, negotiations, and legal action, to recover amounts owed and to foreclose on collateral. While there is always a risk of a future bankruptcy filing of a borrower or guarantor stalling any ongoing or future lawsuit, by delaying any legal action, the lender risks receiving no further payments on its outstanding loan and falling behind any other creditors of the borrower who raced to the courthouse first.

No amount of preparation can fully eliminate the risk of default or non-collection of an outstanding loan. However, by taking a proactive approach to monitoring its loans and protecting its rights related to them, the lender can best maximize its recovery and minimize any loss.