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Collecting Business Debt

by Christopher Ferreira

The key to collecting a business debt, whether by a financial institution, private party lender, or investor, is to recognize and promptly attend to loan defaults. The situation exacerbates when neither the borrower nor the lender responds promptly and appropriately.

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Are You a Debt Collector? Three Scenarios

by Patrick D. Newman

The Fair Debt Collection Practices Act defines a debt collector as "any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due. . . another."

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Collecting Business Debt

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The key to collecting a business debt, whether by a financial institution, private party lender, or investor, is to recognize and promptly attend to loan defaults. Signs of an impending loan default may include delays in meeting deliverables, declining revenues or losses, cash flow issues, delays in billings and collections, growing debt load, and additional cash infusions and related-party transactions. A non-responsive borrower means trouble. The situation exacerbates when neither the borrower nor the lender responds promptly and appropriately.

Once a borrower becomes resigned to the eventual loss of control of its business or property, and before surrendering control, the borrower may attempt to divert as much money or property out of the business as possible. For example, the borrower may allow existing account debtors to prepay invoices at a significant discount for a present cash payment. With respect to real estate collateral, the borrower may enter into leasing arrangements requiring substantial or full payment of rent in advance of, or cancel long term leases in exchange for, a cash payment. To mitigate this diversion, the lender should regularly monitor the borrower's business practices to determine: (i) the collectability of accounts receivable and any departure from past payments, and (ii) whether the borrower is depositing funds in the same account consistent with prior practices. The money that is diverted is usually used by the borrower to support a bankruptcy filing or litigation against the lender.

At the first sign of trouble, the lender should have an attorney review the loan and related documents, including notes and correspondence, to determine whether the lender is well-situated to exercise its rights and remedies under the loan documents. The loan review is essential for identifying drafting errors or other issues that might affect the enforceability of the loan documents, or for identifying any "course of dealing" between the parties that might be construed as altering or modifying the parties' rights and obligations under the loan documents and at law.

A loan "workout" can be an effective tool to get the borrower back on track or to maximize the liquidation value of its business. The "workout" may include the following:

Loan Extension

One of the most common terms of a loan workout is the lender's extension of the loan or loans under a forbearance agreement. Often during the course of a loan, problems arise for which the lender may feel adequately protected during the course of the loan but, as the loan nears maturity and liquidation appears imminent, the picture starts to change. In such a scenario, it is not uncommon for the lender to grant a 60 or 90-day extension of the loan during which the lender agrees to forbear from exercising its rights and remedies under the loan documents to give the borrower time to cure the default or to obtain take-out

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financing from another source. The loan extension should be made pursuant to the terms of a forbearance agreement in which the borrower acknowledges its default and the validity of its loan documentation with the lender.

Loan Documentation

The workout provides the lender with an opportunity to fix any real or perceived problems with loan documentation. In exchange for the forbearance, the borrower will often agree to execute new or amend existing loan documents to address any ambiguities or other drafting issues, or to provide for additional security.

Equity Infusion

As part of a loan extension, the lender may request that the borrower or a third party invest equity in the business to enable the borrower to meet ongoing obligations.

Deed in Lieu of Foreclosure

When there is insufficient value in the lender's real property collateral to secure the debt, the borrower may be willing to give up its redemption rights by deeding the property directly to the lender or its designee to save the cost of a foreclosure. A deed-in-lieu of foreclosure can also be given in exchange for the lender's release of its right to pursue a deficiency judgment or to enforce a personal guaranty.

Release of Collateral

The lender may allow the borrower to sell or lease collateral to obtain additional financing or to apply the proceeds from the sale of the collateral to reduce existing obligations.

Release of Guaranty

A full or partial release of a guaranty or the wavier of any claims against the borrower or its principals, especially where the principals have the ability to meet significant obligations under the guaranty, is often sufficient incentive for officers to cooperate under a workout or orderly liquidation.

Third-Party Turnaround Professionals

It is not uncommon for the borrower to be caught up in financial problems beyond its ability to resolve. A third-party workout professional can provide valuable assistance. The lender may be reluctant to extend a helping hand in workout situations to avoid liability based on the lender's control of the business. The lender can avoid control by requiring the borrower to retain a third-party workout professional of the borrower's own choosing.

Orderly Liquidation

If there is sufficient collateral to protect the lender's security, the lender may want to act more aggressively to a default by liquidating the collateral. The borrower may react by opposing the lending party's collection efforts or filing a petition in bankruptcy. The reasonable middle ground is often an agreement for the total or partial liquidation of the collateral. In this situation, the borrower has the incentive of getting the lender paid in full and retaining any remaining equity in the business.

Financial Reporting

To be effective, the workout should always require the borrower to provide periodic reporting of financial information sufficient for the lender to identify any issues going forward. In addition, the lender should pay close attention to those items that could become a prior lien or charge on the assets securing payment of the loan. Such items include federal and state tax liens, as well as various priority claims for wages and pension benefits.

Waiver and Release

In exchange for any accommodation, the lender should always seek to require the borrower and any guarantor to release the lender from any liability for any claims against the lender, regardless of whether the lender believes the borrower or any guarantor has any valid claims against it. The borrower will usually recognize that this is the price of compromise.

For further information about collecting business debt or loan workouts – or any other banking and finance questions – contact your attorney at Moss & Barnett.

Christopher Ferreira's practice is concentrated in banking and finance matters. He represents financial institutions of all sizes, including community, regional, and national markets, as well as credit unions and securitized investors. Chris represents clients in both loan originations and workouts. He advises management on commercial banking compliance, conducts due diligence and analysis, structures deals, oversees collateral securitization, and handles credit workouts and enforcement actions.

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