Know Your Borrower

Amundsen Davis Financial Services Alert
September 29, 2017

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In the 1980s, President Ronald Reagan introduced the American population to the concept of "trust, but verify." President Reagan was actually quoting an old Russian proverb, useful during his negotiations with Mikhail Gorbachev. While the phrase created great political theater for Reagan, the catchphrase can readily be applied to financial services, providing a road map of sorts for loan officers and credit committees who are considering new credits.

As part of the due diligence process, a lender will frequently request a large amount of documentation from a prospective borrower. This documentation includes internal financial statements, audited financial statements, tax returns, and personal financial statements from either the organization's principals or any guarantors. While tax returns and audited financial statements can have certain indicia of real liability (although they are not always free from error), personal financial statements present unique challenges.

If the borrower defaults, a workout officer – acting in conjunction with outside counsel – frequently pours through personal financial statements, looking for assets available to satisfy the debt and/or fraudulent statements, which can be used to pursue a principal or a guarantor. Finding assets available to help satisfy the debt is a victory of sorts; however, pursuing a fraud claim can be cold comfort.

This is where "trust, but verify" can be applied. Loan officers would be well advised to trust, but verify when reviewing personal financial statements. Here are several frequent areas which can lead to problems:

- Ownership of Real Estate. A number of states permit married couples to own real estate as "tenants by the entireties." As a result, entireties real estate cannot be held or attached for any debt which is not a joint debt of the husband and wife. When reviewing a personal financial statement, the maker will frequently include a martial home among the assets, but the lending institution is not going to be able to reach that home without an indemnifying mortgage or a pledge of some sort from the non-debtor spouse.
- When reviewing the ownership of real estate, a loan officer should inquire about the real estate. For example, if one of the married parties purchased the real estate before the couple married or if the parties purchased it together before the marriage, the real estate may actually be held as tenants in common, or simply as joint tenants, thus making a guarantor's share of the real estate available to satisfy a deficiency claim.

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- If it is necessary to obtain a spousal guaranty in order to be able to reach any equity in the real estate, consider the impact of the Equal Credit Opportunity Act (ECOA) on the request. ECOA allows for spousal guaranties in certain settings; however, a loan officer will want to check with a compliance officer before making the request.
- Many jurisdictions allow an individual to exempt retirement accounts or insurance policies from creditors' claims. That said, if the retirement account or insurance policy has not been created in strict compliance with the exemption statutes, it may be available to a lender seeking to collect on a claim.
- Interests in closely held corporations or limited liability companies are another area of concern. If a lending institution is relying on substantial value in a closely held business, it is best to ask whether the shares are subject to a "buy-sell" agreement. If the asset is an interest in a limited liability company, certain jurisdictions do not permit a creditor to foreclose on an ownership interest, but limit a lender's remedy to the income stream only. Restrictions of this type may drastically change the valuation of these assets.
- Art collections and other memorabilia, such as classic cars, can be a nightmare for a lending institution during the collection process. Unless the art collection contains works by known masters, or there is a readily available market, a loan officer considering those as viable collateral may need to discount the value of the assets for purposes of reviewing a personal financial statement.

Obviously, asking some of these questions during the loan intake process could inspire a potential borrower or guarantor to clean up any issues. On balance, understanding the true picture of the guarantor's financial health, presents the lending institution with the opportunity to verify the information, while trusting that the credit will work out to the benefit of both parties.