Loss Mitigation Strategies for Commercial Creditors

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It seems that every few years, we experience an unprecedented event that significantly affects the world. From a once-in-a-generation recession to a once-in-a-century pandemic, trade creditors and inventory lenders constantly face new challenges. However, through the ever-changing lending landscape, there remain tried and true ways commercial creditors can mitigate loss. This article highlights a few of those.

Wise Business Practices

The first step in loss mitigation is to make wise business practices routine, such as knowing your customer and the status of your collateral.

Determining customers' normal types of transactions, payment methods, and financial situation during underwriting and then continuing to monitor those during the credit relationship can help ensure repayment and reduce outsized losses. Creditors can usually obtain this information through detailed applications, credit and public record reports, and bank letters. When pulling a consumer credit report, e.g., on a principal or guarantor, it is always good practice to confirm your authority to do so, with written authorization from the subject of the report being the clearest form.

Additionally, knowing whether a commercial customer is current on their payments to other creditors and whether they are a party to any recent litigation or bankruptcies can help paint a complete picture of their financial situation. Validating a customer's identity and payment methods, particularly for email and online transactions, will help creditors know their customers and prevent fraud. Of course, it's also important to set alerts for large and late balances and immediately follow up on any material defaults.

Keeping track of any collateral is also essential to mitigating loss. Secured creditors should routinely perform collateral audits to keep up with the status of any financed inventory, equipment, or other collateral. Periodically asking routine questions to borrowers about the location of collateral, how it is maintained, its condition, and its insurance status (if applicable) will all help a lender protect its best hedge against large losses.

Wise Legal Moves

In addition to the low-hanging fruit of prudent underwriting and account monitoring, commercial creditors can often improve their collection position with some basic legal maneuvers. Among the more common are having strong, clear credit contracts, obtaining personal guaranties to support corporate obligations, holding collateral or collateral title documents as practical hurdles to sales out of trust, exploring inter-creditor agreements when valuable or recurring collateral secures more than one loan, and having well-trained collections personnel with legal experience. Put another way, it is almost always best to have broad clear contractual rights and to have collections personnel that know how to leverage those.

Commercial creditors should also consider obtaining and perfecting a security interest in valuable debtor collateral where feasible. This would often be at least the goods being sold on credit or otherwise financed by the creditor. A perfected security interest can dramatically improve a creditor's collection options following default and in any litigation or bankruptcy that follows. Under the UCC, a lender obtains a security interest when the security interest attaches to the collateral. Attachment generally requires the lender to give value for the security interest, the debtor to have rights in the collateral, and an agreement authenticated by the debtor granting security rights to the creditor. Then, to obtain priority against other claimants (e.g., other secured lenders, bankruptcy trustees, certain purchasers, etc.), the creditor usually must perfect its security interest. Perfection is achieved in various ways depending on the nature of the loan and collateral. The most common methods are filing a financing statement and/or controlling the collateral, but the details are technical and should be determined with good legal advice.

Wise Steps After Default

We would not be writing about loss mitigation strategies if borrowers never defaulted, but of course, they do, often at great cost to commercial creditors. Therefore, it is crucial to have an action plan in place. Following a default, a prudent commercial creditor will assess the situation and act quickly. As soon as possible, you should determine the status of any collateral and demand that the borrower turn it over immediately. Routinely conducting inventory audits and collateral status checks, as discussed above, can inform this process. To the extent collateral cannot be quickly and voluntarily recovered, the creditor should determine what legal remedies it has available, such as

repossession without a court order, replevin or local equivalent with a court order, a temporary restraining order, expedited discovery, etc.

In certain cases, pre-judgment attachment of non-collateral assets, claims against third parties, involuntary bankruptcy or receivership, and other extraordinary steps may be available with the advice and support of counsel.

To the extent a deficiency remains, the creditor may decide to pursue a money judgment through a lawsuit. Every lawsuit is different as local court rules vary and debtors react in myriad ways. Collections suits may conclude by settlement, consent judgment, default judgment, summary judgment, bench trial, jury trial, dismissal, intervening bankruptcy filing, and otherwise. Obtaining a final judgment can take months or years, in some cases. A smart creditor needs to be prepared for a lengthy process and constantly re-evaluate when to dismiss the case and stop throwing good money after bad on a given debtor. Of course, there may be deterrent and precedent issues to consider if the creditor has a portfolio of collections litigation.

Post-Judgment Considerations

Obtaining a judgment is not often the end of the road to recovery. If the defendant still does not pay, the creditor can take additional steps to collect the judgment. Some courts allow for post-judgment discovery to determine what assets the debtor has and where they can be found. Post-judgment discovery can also allow a judgment creditor to obtain bank and other financial account records, identify employment status and other income streams, and search for cars, real estate, stock, and assets hidden in other entities.

Worthwhile assets might be levied upon according to local requirements, and sources of income to a judgment debtor can often be garnished up to a certain level. Judgment liens can typically be recorded in the relevant jurisdiction to encumber real estate owned by the judgment debtor and/or domesticated in other states where assets are located. Some states have homestead exemptions and other carveouts to consider.

It is also important to look for transfers from the borrower to family members, friends, and other closely held companies. If the borrower transferred assets to thwart collection, a creditor may have options against the transferee(s) under fraudulent transfer laws.

Collecting a judgment can also be a long, complicated process, and it may be necessary to renew the judgment before it expires under the rules of the issuing court or state. Experienced collection counsel can assist in evaluating and pursuing the best options.

Adventures in Bankruptcy

When a borrower or related party files bankruptcy, the creditor must get its bearings. First, identity who filed—is it your primary debtor, a guarantor, or some other party? The bankruptcy can affect a creditor's rights differently depending on the relationship of the bankruptcy debtor to your borrower(s). Secondly, identify whether the debtor filed the bankruptcy under chapter 7, chapter 11, or chapter 13. There are different processes to be aware of depending on the chapter. Lastly, make sure someone keeps track of deadlines, including the meeting of creditors, the deadline for filing proofs of claim, and objecting to discharge.

In any case, it is vital to be aware of the automatic stay. There can be serious consequences for violating the automatic stay. Thus, when you get notice of a customer bankruptcy, do not contact the debtor, ask the debtor to pay, try to perfect your security interest, or do anything to pursue recovery without consulting an attorney. A creditor can be hit with sanctions for violation of the bankruptcy stay, and the standard for what constitutes a violation is very low.

Preference avoidance actions can be another consequence of bankruptcy. Subject to some technicalities and defenses, these can undo judgments entered, payments made, or security interests perfected within the months before the bankruptcy. The standard for a trustee avoiding payments to a creditor is not terribly high and does not require intent to receive a preferential transfer.

Remember that perfected security interest? It may very well come in handy during bankruptcy. If your collateral is still fully or partially available, you can assert a priority claim up to the value of that collateral. You might also be able to have the stay lifted to recover your collateral and/or prohibit the debtor from using it in a reorganization effort.

Not all debts are dischargeable in bankruptcy. If a creditor has a colorable fraud claim or a judgment on fraud, it might be able to use that to prevent discharge of some or all of the obligation to the creditor, meaning the obligation will continue to follow the debtor post-bankruptcy.

Bankruptcy rules and procedures are complex and should be considered carefully with counsel, but experienced commercial creditors will generally keep these issues in mind.

Collecting SBA Loans

In the wake of the Covid-19 pandemic, the SBA extended several relief options to help organizations recover. The largest of these is the Paycheck Protection Program ("PPP"), created by the CAREs Act. PPP loans are offered to certain businesses to provide money to fund payroll and other eligible expenses. Under certain circumstances, PPP loans are partially or fully forgiven by the SBA, and the loans that are not forgiven are guaranteed by the SBA—meaning, in the event of default, the SBA will reimburse the creditor for the remaining balance once certain SBA conditions and requirements have been as satisfied.

Most other SBA-guaranteed loans are secured by collateral, and in the event of default, the lender must make its best efforts to liquidate the collateral and/or collect from the guarantor before the SBA will reimburse the remaining balance. PPP loans, however, are unsecured, with creditors required to make their best, reasonable efforts to collect on defaulted PPP loans in the same manner they would any other unsecured loan. This includes attempting a workout, accelerating the loan, researching the borrower's assets to determine whether a money judgment would result in recovery, and creating a litigation plan to submit to the SBA.

SBA loan program requirements, especially the Covid-19 related loan programs, are constantly changing. For example, PPP loan forgiveness applications were, prior to August 4, 2021, solely the creditor's responsibility to collect and submit to the SBA. However, the SBA opened an online portal whereby businesses that borrowed up to $150,000.00 can submit their own forgiveness applications. The SBA also recently introduced a score to determine if a borrower qualifies for a Second Draw PPP Loan and expanded the deferment period during borrower's appeals.[1]

Conclusion

Customer default is an ever-present risk for trade creditors and inventory lenders, but with prudent underwriting, monitoring, and legal maneuvering, commercial creditors can lessen than risk and improve their recoveries significantly.

For more information or guidance, contact Miller & Martin attorney Jason McCarter or a member of our Commercial or Bankruptcy & Creditors' Rights teams.

[1] Alan Gassman, *Borrower Friendly PPP Loan Forgiveness Regulatory Changes Provided By The New SBA Regulation*, Forbes (Aug. 5, 2021, 7:07 PM).