

Commercial Lending Review

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Analogous to real estate title insurance, UCC insurance insures title to personal property.

Article 9 Collateral Insurance Shifts Risk for Lenders

By Theodore H. Sprink

UCC insurance insures the commercial lender's security interest in non-real estate collateral.

Traditionally, commercial and residential real estate lenders and investors have used title insurance to minimize documentation errors and to perform processes associated with perfecting lien priority. Title insurance protects credit quality, secondary market value and liquidity.

As late as the mid-1950s, real estate title insurance was not universally accepted or used by lenders. Lawyers' legal opinions and abstracts were widely used in the nation's real estate markets. Standard real property title policy forms of coverage, endorsed by the American Land Title Association (ALTA), were still a decade away. Today, title insurance is a cornerstone of traditional real estate lending.

Title Insurance for Non-Real Estate Loans

Over the last few years, a new concept of title insurance has evolved primarily within the private equity space. This new insurance is available to lenders for which "reliance collateral" is personal property as defined by Article 9 of the Uniform Commercial Code (UCC), that is, title insurance for non-real estate loans.

Non-real estate assets are often called personal property, or Article 9 collateral. Personal property includes inventory, furniture, fixtures, equipment, accounts receivables, deposit accounts, general intangibles, securities and pledges (often crucial to the mezzanine loan transaction).

The title industry has essentially adapted the standard ALTA real estate title insurance policy form to provide the benefits of title insurance to commercial lenders securing loans with non-real estate collateral. These UCC insurance policies currently cover an estimated \$450 billion in secured lending.

UCC insurance insures the commercial lender's security interest in non-real estate collateral for validity, enforceability, attachment, perfection and priority. Policies include UCC search and filing services and are frequently issued on a postclosing basis. In addition, UCC insurance protects commercial lenders against fraud, forgery, documentation defects, search office errors and omissions, indexing problems and financing statement inaccuracies.

UCC insurance provides cost-of-defense coverage in the event of a third-party challenge to the lender's security interest and lien priority. Loans that are insured tend to have greater value in the secondary market than loans that are not insured. Policies are for the life of the loan and assignable.

Pitfalls of UCC Search Vendor Indemnification

UCC insurance overcomes limited UCC search vendor indemnification in connection to search office errors and omissions, indexing inconsistencies and financing statement inaccuracies. Without UCC insurance, a lender's recourse to an inaccurate search or filing function from leading search and filing vendors is limited to the cost of the service rendered by the vendor.

Millions of dollars of collateral could be lost due to a search, filing or clerical error by the vendor, and the lender's recourse could be limited to, for example, \$100 dollars, that is, the cost of the search or filing service.

Theodore H. Sprink is Senior Vice President and National Marketing Director for the UCC Risk Management Program of the Fidelity National Financial Family of Companies, Jacksonville, Florida. Contact him at tsprink@fnf.com.

Most commercial loan documentation defects that lead to a lender's security interest being jeopardized are clerical in nature:

- Incorrect name of borrower
- Search of the wrong jurisdiction
- Wrong state of filing
- Not filing the appropriate documents
- An error in the collateral description.

Often, junior staff at either the bank or the law firm is responsible for these critical details. UCC insurance imposes a discipline and provides an insurance product that can significantly reduce these risks to reliance collateral.

Insolvency proceedings often result in a challenge to the lender's security interest, either by the bankruptcy trustee, the creditor's committee or the borrower. Recent cases show the lender's exposure to relying on search vendors and/or outside counsel to assure proper attachment, perfection and priority of its security interest in personal property:

- The "failure to file" a UCC-1 financing statement by outside counsel led to a legal malpractice judgment against a law firm in an action brought by the client in *Kory v. Parsoff*.¹
- An "incorrect/ambiguous financing statement" limited collateral subject to a bank's filing in *Shelby County State Bank v. Van Diest Supply*.²
- A "UCC search vendor's liability for damages" was limited to \$25 for the failure/inaccuracy of the vendor's search in identifying prior liens in *Puget Sound Financial, LLC v. Unisearch, Inc.*³
- A "defective description in collateral" and "incorrect filing jurisdiction" led to a lender failing to properly perfect its security interest in *Fleet National Bank v. Whippany Venture*.⁴

UCC Insurance Broadens Protection for Secured Lenders

UCC insurance enables lenders to outsource UCC search, document preparation and filing

functions, while wrapping the entire transaction in an insurance policy offered by Fortune 500 insurance companies, effectively shifting risk for the proper attachment, perfection and priority of their security interests in non-real estate collateral.

UCC insurance can complement, if not replace, the costly traditional legal opinion crafted by borrower's counsel with respect to perfection and priority and provide cost of defense in the event something goes wrong.

With regard to high-risk/low-billable documentation matters, outside counsel would be able to more appropriately focus on negotiating and drafting primary loan documents, letting the UCC insurers worry about UCC matters. The insurance coverage would also relieve liability to outside counsel in connection to priority and perfection issues.

Benefits of UCC Insurance

UCC insurance can reduce loan origination costs, increase lender and investor transaction protection (as well as transparency), eliminate UCC-related documentation defects and filing errors and shift risk from outside counsel with regard to the legal opinion. UCC insurance has further served to enhance the strength and value of loans and loan portfolios securitized or otherwise sold into the secondary market.

Endnotes

¹ *Kory v. Parsoff*, 745 N.Y. S. 2d 218 (2002).

² *Shelby County State Bank v. Van Diest Supply*, 303 F. 3d 7th Cir. (2002).

³ *Puget Sound Financial, LLC v. Unisearch, Inc.*, 146 Wn. 2d 428 (2002).

⁴ *Fleet National Bank v. Whippany Venture, Inc.*, 370 B.R. 762 (d. Del. 2004).

Contingent Liquidity Pricing

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processes and to improve profitability by asking the next logical set of business and risk questions. Some of these questions will address how banks can create and proactively offer to potential borrowers deal structures

that achieve risk-adjusted return targets without necessarily increasing customer payments but by enhancing covenant practices to reduce draw in event of default and improve overall economic profit by customizing deal structures to meet borrowers' primary needs (in comparison to standard structures).

Endnotes

- ¹ Board of Governors of the Federal Reserve System, *Survey of Terms of Business Lending*, Federal Reserve Board Statistical Releases, E.2 (Sept. 2008).
- ² *Gold Sheets*, a Reuters LPC Publication, Oct. 15, 2008.
- ³ Elliot Asarnow and James Marker, *Historical Performance of the U.S. Corporate Loan Market: 1988–1993*, Exhibit 9.
- ⁴ See, for example, Scott D. Aguais and Lawrence R. Forest Jr., *The Future of Risk-Adjusted Credit Pricing in Financial Institutions*, RMA J. (Nov. 2000).
- ⁵ Pierre Paulden and Caroline Hyde, *Citigroup, Credit Suisse Link Loans to Swaps in Shift*, *Bloomberg.com*, Dec. 10, 2008.
- ⁶ Ioana Barza and Maria C. Dikeos, *2008 Ends As Lending Grounds to a Halt; Remaining Market Players Take Stock*, 23 U.S. SYNDICATED LENDING REVIEW, LPC GOLD SHEETS 1 (Jan. 5, 2009).

Acquisitions and Their Effect on Loan Covenants

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Endnotes

- ¹ For an excellent analysis on permitted acquisitions, which includes a brief discussion of the topic of this article, see Joel F. Brown and Timothy P. Davitt, *Negotiating and Documenting Permitted Acquisition Facilities*, COMMERCIAL LENDING REV., May–June 2005.
- ² It should also be noted that if the document is silent on the issue, either intentionally or because the parties did not contemplate the issue, general accounting rules would normally not include the pre-acquisition date EBITDA in the borrower's reported results, as that was not yet a part of the borrower's operations.
- ³ While EBITDA is being calculated on a *pro forma* basis, capital expenditures do not run through the company's income statement and so are not part of EBITDA, and most fixed charges are added back to net income in calculating EBITDA.
- ⁴ Many loan agreements do require that any *pro forma* calculations must also assume that any additional debt incurred/assumed with the acquisition was incurred/assumed on the first day of the 12-month period as well. While this will not change the EBITDA portion of the fixed-charge ratio (because interest expenses are added back in the calculation), it will increase the fixed-charge portion of the ratio because of the *pro rata* treatment of the required debt payments. Questions also arise with this in deciding what interest rate to apply during the preacquisition period if the additional incurred/assumed debt carries a floating rate of interest.
- ⁵ The same concepts and rules for adjustment for the fixed-charge coverage ratio would also apply to a similar covenant,

the interest-coverage ratio.

- ⁶ For instance, the borrower may argue that no increase is appropriate, because the acquired EBITDA simply increases the amount of cash flow available to service the debt, and any debt that is incurred with the acquisition is properly covered and dealt with by the leverage covenants and customary restrictions prohibiting incurring additional debt.
- ⁷ It should be noted that even though the covenant levels are being increased, the borrower may still have a more favorable set of covenant tests after the acquisition if the acquired company is expected to grow its EBITDA. Because the increase is typically done as a flat dollar increase on each of the test dates, while the existing covenants (before the adjustment) usually have increased dollar amounts each year, any EBITDA growth from the acquired business can help cover the EBITDA growth required for the original borrower.
- ⁸ Waiting until the end of the first *full* quarter-end date after the acquisition is admittedly not an exact *pro rata* phase-in of the EBITDA increase, as the period from the acquisition date to the end of *that* quarter would be left unadjusted. The parties to the agreement would have to decide if the complexity and difficulty of the drafting and monitoring required to get complete precision on this matter is warranted when making such an adjustment.

Loan Documentation

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In the alternative, a lender may want to work with a borrower to salvage the loan, using the state of default and the threat of harsher remedies as leverage to bring the borrower into compliance and to better secure the lender. Such workout solutions should always include a detailed forbearance agreement wherein the obligor parties are required, as a condition of the workout, to waive any and all claims that they may have against the lender (including its loan officers, employees, agents and attorneys). The forbearance agreement is important in such cases, because distressed borrowers often blame the lender for the failure of their project and attempt to sue the lender under various liability claims. A well-drafted forbearance agreement should foreclose this possibility and give the lender additional protection. The workout may also include the provision of additional (cash or real estate) collateral for the loan; tighter reporting provisions and lender approval requirements; and (where applicable) the requirement that the borrower hire an experienced (and lender-approved) general contractor, construction manager or property manager. In addition to

keeping a potentially unmanageable (and possibly unsalable) asset off the lender's books, such a solution has the advantage of keeping the borrower and each of the loan guarantors (who have the double-edged incentive to avoid personal liability in the event of project failure and to earn financial rewards in the event of success) on the project team.

Conclusion

It is easy to be a profitable lender or a star loan officer when the markets are humming along. It is much harder to maintain that luster when the market is crashing. Lenders can soften the landing for themselves and their borrowers by paying attention to the covenants in their loan documents. By testing covenants frequently, lenders can identify problems early and try to work with borrowers to head off defaults.

Accounting

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the proposed FAS) whose effective date is before March 15, 1992. However, the FASB concludes that for pronouncements whose effective date is after March 15, 1992, and for entities initially applying an accounting principle after March 15, 1992 (except for EITF consensus positions issued before March 16, 1992, which become effective in the hierarchy for initial application of an accounting principle after March 15, 1993), an entity is required to follow the guidance of the proposed FAS.

The FASB notes that certain accounting standards have allowed for the continued application of superseded accounting standards for transactions that have an ongoing effect in an entity's financial statements. That superseded guidance, the FASB notes, has not been included in the codification. Such superseded guidance will be considered grandfathered and will continue to remain authoritative for those transactions after the effective date of the proposed FAS. The FASB provides the following examples of such grandfathered items even though the list is not comprehensive:

- Pooling of interests in a business combination (originally addressed by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*) described in paragraph B217 of FAS-141, *Business Combinations*

- Pension transition assets or obligations described in paragraph 77 of FAS-87, *Employers' Accounting for Pensions*
- Employee stock ownership plan shares (originally addressed by Statement of Position [SOP] 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*) purchased by and held as of December 31, 1992, as described in paragraphs 97 and 102 of SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*
- Loans restructured in a troubled debt restructuring before the effective date of FAS-114, *Accounting by Creditors for Impairment of a Loan*, described in paragraph 24 of FAS-118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*
- Stock compensation for nonpublic and other entities (originally addressed by FAS-123, *Accounting for Stock-Based Compensation*, or APB Opinion No. 25, *Accounting for Stock Issued to Employees*) described in paragraph 83 of FAS-123 (revised 2004), *Share-Based Payment*

Effective Date and Transition

The FASB notes that the proposed FAS became effective July 1, 2009, except for nonpublic entities that have not followed the guidance included in TIS Section 5100, "Revenue Recognition," paragraphs 38–76. Those entities are required to account for the adoption of the guidance in the proposed FAS as a change in accounting principle on a prospective basis for revenue arrangements entered into or materially modified in those fiscal years beginning on or after December 15, 2009, and interim periods within those years. The FASB clarifies that if an accounting change results from the application of that guidance, an entity will disclose the nature and reason for the change in accounting principle.

The FASB concludes that, except as described above, any effect of applying the provisions of the proposed FAS will be accounted for as a change in accounting principle or correction of an error, as applicable, in accordance with FAS-154, *Accounting Changes and Error Corrections*. The FASB notes that an entity will be required to follow the disclosure requirements of FAS-154 and disclose the accounting principles that were used before and after the application of the provisions of the proposed FAS and the reason that applying the proposed FAS resulted in a change in accounting principle or correction of an error.