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WHAT'S INSIDE

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LIBOR

Alabama homeowners target big banks in Libor scandal

A group of homeowners has filed a class-action lawsuit against major lending institutions for manipulating Libor to artificially inflate interest rates on adjustable mortgages and other financial instruments for nearly a decade.

Adams et al. v. Bank of America Corp. et al., No. 1:12-CV-07461, complaint filed (S.D.N.Y Oct. 4, 2012).

According to the complaint filed in the U.S. District Court for the Southern District of New York, more than a dozen American and European banks conspired to fix the London InterBank Offered Rate, or Libor, between 2000 and 2009.

The defendants include such banking industry giants as Bank of America Corp., Barclays, Deutsche Bank AG and JPMorgan Chase.

The suit is widely reported to be the first class-action alleging Libor manipulations brought by homeowners rather than investors or government entities.

The five plaintiffs, all homeowners and residents of Mobile, Ala., whose mortgages were collateralized into mortgage-backed securities by various lenders and sold to investors, according to the complaint.

The suit claims that those lenders and other unnamed co-conspirators entered into a "global conspiracy" to fix or set Libor, raising interest rates on adjustable-rate notes and thus increasing the gap between what the banks paid to investors and the amount collected from mortgage borrowers like the plaintiffs.

The five named plaintiffs are homeowners in Mobile, Ala., pictured here, whose mortgages were manipulated by various banks using Libor.

The first named plaintiff, Annie Bell Adams, is a pensioner whose home was repossessed, allegedly as a result of the increased rates.

Libor is a set of interest rates used as a benchmark for everything from mortgage loans to derivative

CONTINUED ON PAGE 16

COMMENTARY

The small-business borrower and the continuing financial crisis

Benjamin W. Baldwin of Robinson, Bradshaw & Hinson discusses issues that small businesses should keep in mind when seeking bank financing in the current economy.

SEE PAGE 3

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Editor: Catherine A. Tomasko
Cath.Tomasko@thomsonreuters.com

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Thomson Reuters
175 Strafford Avenue
Building 4, Suite 140
Wayne, PA 19087
877-595-0449
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TABLE OF CONTENTS

The small-business borrower and the continuing financial crisis

By Benjamin W. Baldwin, Esq.
Robinson, Bradshaw & Hinson

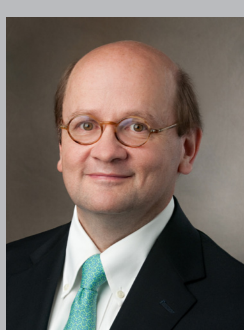
"The wind and the waves are always on the side of the ablest navigator."[1]

Life for small business borrowers has improved significantly since 2009, but that is damning the economy with rather faint praise. In fact, it remains a challenging environment, and global economic conditions do not currently indicate a significant rebound in the United States in the near future. How can a small business in need of bank financing these days maneuver effectively?

This commentary explores the question and seeks to offer general suggestions for small businesses and their counsel, from the selection of a lender to managing problems and default scenarios.

WHICH BANK IS BETTER — LARGE OR SMALL?

Common intuition, statistics and the experts all support the notion that small businesses are better off dealing with community banks as opposed to larger regional or nationally scaled banks, especially when the businesses experience challenges or difficulties. Of course, such advice may come too late for small, struggling companies that selected larger banks before those companies' fortunes soured, or small businesses that selected smaller banks that were later acquired by larger ones. (By way of definition, the Federal Reserve considers a community bank to be one with total assets of $10 billion or less.[2])



Benjamin W. Baldwin practices with **Robinson**, **Bradshaw & Hinson** in Charlotte, N.C. His practice covers a broad range of corporate finance and commercial transactions, with an emphasis on mergers and acquisitions, and senior and mezzanine lending. He can be reached at BBaldwin@rbh.com.

Why is a small or community bank a better option for the small business borrower? Because of the types of information relied on by the banks in making credit decisions, and the processes by which those decisions are made. Large banks and community banks tend to differ in both respects.

Common intuition, statistics and the experts all support the notion that small businesses are better off dealing with community banks.

First, in terms of the types of information relied on by the banks in making credit decisions, community banks tend to take a more subjective approach than their larger counterparts. This type of banking focuses somewhat less on objective credit scores and more on the customer relationship and community considerations, and the bankers making these credit decisions may rely on discretionary powers and "soft information" that is less quantifiable.[3]

Furthermore, inasmuch as financial statements produced by many smaller companies may not necessarily conform to "generally accepted accounting principles," those companies' lenders are going to need to consider a broader range of information (based on the banker's knowledge of and familiarity with the company and its role in the local business community), and a local community bank is naturally going to be in a better position to engage in that exercise than is a national bank. With a national bank, the credit decision may well be made by a loan officer in another office in a different city.[4]

Second, in terms of process, because of the way community banks and larger banks are structured and because of a community bank's more detailed understanding of the smaller company and its ties to the community, small banks tend to be more agile in reacting to the needs of their customers. This is in part because community banks face lower costs and fewer bureaucratic barriers in evaluating their customers and monitoring their performance. In addition, community bank loan officers generally have more autonomy to make executive credit decisions than loan officers at larger banks. Credit decisions by large banks will often involve participation by officers with limited knowledge of the company (due to geographical separation or loan officer turnover) and in addition some sort of head-office approval. In contrast, a local community bank loan officer will often have broad discretion and authority to make a credit decision and in a more expeditious manner.[5]

Though from a high-level, statistical perspective, community banks seem to be playing a somewhat smaller role in the overall economy than was the case a couple of decades ago, that decline is mainly a function of absorption by larger banks (as opposed to poor performance or other negative attributes) and somewhat larger regional banks have also been subject to the same trend over time.[6] Furthermore, community banks continue to be commercial mainstays in rural and smaller metropolitan areas, and especially in the central United States. Finally, community banks seem to be meeting fairly well the challenges posed by the Great Recession, including the need to diversify their investments to avoid overexposure to troubled businesses such as those involving commercial real estate.[7]

CONSIDERATIONS FOR AVOIDING AND MANAGING DIFFICULTIES

As discussed above, if a small business is in the position of selecting a bank for its credit needs, it should seriously consider going with a small or community bank instead of a larger or national bank with a "household name." Once the selection of a bank has been made, how can the small business best navigate the still-challenging waters of the current economy?

Avoiding difficulties

Obviously, from a business perspective, the borrower will want to operate as efficiently and as profitably as it can by enhancing its revenue stream and eliminating unnecessary expense. But how can the company protect itself from a legal point of view as a small-business borrower?

First, the borrower should develop a reliable system for the preparation of its financial statements and then should be disciplined about using that system. The importance of having reliable financial statements from the loan application process through the final repayment of the loan cannot be overstated. If the borrower does not have an experienced chief financial officer with an adequate staff to perform this function, the company will want to hire an accounting firm to perform this function on its behalf. If the lender in question requires an annual audit by a certified public accountant, such a system will certainly be required.

> With a national bank, the credit decision may well be made by a loan officer in another office in a different city.

Second, the borrower should read and attempt to negotiate its loan documents and retain experienced loan counsel to assist it in doing so.[8] The small-business borrower may have a good relationship with the banker who originated the loan and even the person who will be administering the loan for the bank. Consequently, the borrower may be tempted not to "sweat the details" and trust that it will be treated fairly in the future, even in the event of difficulty. But this approach would not be advisable. The bank may be acquired by a bigger institution, or there may be other personnel changes at the bank that alter the cast of characters, such that if and when the borrower's business takes a turn for the worse and there is a need to obtain concessions from the lender, the borrower is suddenly staring across the table at an unfamiliar face. This eventuality is certain to happen if the loan is moved to the bank's "workout" group, where the borrower will likely encounter not only unfamiliar faces, but an altogether different and less accommodating style, approach and attitude.

> Community banks continue to be commercial mainstays in rural and smaller metropolitan areas.

Thus, what the documents say is of the utmost importance. Following are some of the salient points for the small-business borrower's consideration.

- Financial covenants. The lender will be keenly focused on the borrower's financial covenants. These covenants will be based on the borrower's projections, so the borrower should take the time to prepare *realistic* projections that will not paint too rosy a picture of its future, *likely* performance. Then the borrower and the lender should work together in devising financial models that will yield financial covenants that will leave enough room on the downside for the company to operate without triggering a default. Finally, the borrower and its counsel will want to make sure the definitions used in the financial covenants work from a technical point of view (that is, are the accounting concepts internally consistent, and is the timing of the application of the covenants in sync with the timing of the company's performance, calculations and financial reporting obligations)?
- Carve-outs. Does the borrower envision needing future financing for other purposes, such as for an equipment purchase or a capital lease? Will it need flexibility to do acquisitions or asset dispositions? The loan agreement will contain negative covenants that restrict these and many other activities, so the borrower will want to negotiate exceptions or "carve-outs" to these restrictions. The first draft of the loan agreement will also probably include broadly stated propositions in the form of warranties and covenants with which, as a technical matter, it may be difficult, if not impossible, for the borrower to comply. Thus, the borrower and its counsel should consider where the borrower needs and then try to negotiate for materiality or "material adverse effect" qualifiers for those provisions.
- Events of default. The events of default are what trigger the lender's remedies, so they are of critical importance. The lender will likely not permit very much negotiation on these provisions, but the borrower should at least try to (a) obtain a grace period and/or an opportunity to cure as many kinds of default as it can, and (b) eliminate any events of default based on the occurrence of an MAE or any other event as to which the lender deems itself to be insecure and uncertain. These kinds of defaults are inherently vague and have the potential to put the borrower on uncertain ground in its relationship with the lender.[9]

> A borrower should develop a reliable system for the preparation of its financial statements, and then it should be disciplined about using that system.

- Ancillary documents. The loan agreement will be the centerpiece of the documentation and will naturally attract most of the attention of the parties, but the borrower and its counsel will want to be sure to read and negotiate all of the ancillary documents (such as the security agreements, mortgages, pledge agreements, guaranties, *etc*.) as well because oftentimes, some of the most overreaching and broadly drafted provisions may be found there. The loan agreement will certainly provide that a default under an ancillary document will constitute a loan agreement default, so it is important that the ancillary documents be consistent in all respects with the terms of the loan agreement.

- Collateral matters. The lender's underwriting for every deal is different and, in some cases, for credit reasons, it won't be possible for the borrower to succeed in all of these respects but if possible, the borrower will want to try to:

(1) Avoid having the business owners give personal guaranties for the loans. If the lender ultimately insists on having personal guaranties, the guarantor should try to provide that the lender will be required to recover first from "business collateral" (*i.e.*, assets of the borrowing entity) before proceeding to recover on the guaranty or, better yet, provide that the lender's recovery on the guaranty will be limited to any collateral pledged by the lender to secure the loan, such as the guarantor's stock owned in the borrower. In any event, any business owner or other guarantor will need to avoid agreeing to execute a guaranty that requires the execution by his or her spouse since such a guarantor would make the guarantors' home (or any other assets held as "tenants by the entirety") available to the lender as a source of recovery upon enforcement.[10]

(2) Avoid assignment of third-party contracts as collateral. These third-party contracts may require consent in the event of a collateral assignment, which could delay or hamper the process of closing the transaction. Also, the security agreement providing for this kind of lien will likely provide that the lender may correspond with third-party account debtors (*i.e.*, customers of the business) to collect payment, and this kind of communication can be very disruptive to the borrower's business. At a minimum, the borrower should try to ensure that the lender's right to deal directly with the borrower's customers arises only upon the occurrence of an event of default.

(3) Ensure, in the case of a stock pledge securing the loan, that the lender's right to control the voting of the pledged stock, and the right to payment of dividends, will arise only upon the occurrence of an event of default. The first draft of the loan documents may well contemplate that the lender would have these rights immediately and without a default, but this may not really be the intent of the lender, and it certainly is not in the best interests of the borrower.

> The borrower and the lender should work together in devising financial models that will yield financial covenants that will leave enough room on the downside for the company to operate without triggering a default.

Managing the difficulties once they arise

The subject of loan workouts is one that rightfully deserves its own article, and this is not the proper occasion in which to go into a lot of detail, but following is a very general treatment of the subject.

In the first instance, the borrower would be well advised to anticipate issues before they become serious and be transparent with the lender with respect to those issues. If the company foresees that its performance is likely to suffer in the near term, it will be easier and less expensive to negotiate a more routine financial covenant amendment on the front end before the default occurs, rather than to negotiate a more fulsome amendment and waiver (for example, one involving a payment default) down the road. Doing so will also tend to encourage trust and confidence on the part of the lender. In this regard, the borrower should be ready to explain the issues and its plans for addressing them.

Once an event of default does occur under a loan facility, the situation immediately becomes very serious for the borrower because, at that point, the lender has at its disposal a wide array of remedies (including the termination of the borrower's right to make future borrowings under a line of credit, the charging of default interest and late charges, and foreclosure on the lender's collateral, which itself could be disruptive, if not fatal, to the borrower's business).

How things unfold will depend on the severity of the problem and the borrower's prospects. On one hand, the matter might be resolved with a relatively simple waiver and/or amendment to the loan documents to give the borrower time to work itself out of the difficulty (referred to below as an "amendment scenario"). On the other hand, in a more extreme case in which the business is more troubled and the loan relationship not salvageable, the default will provide the lender with an opportunity to exit the relationship and force the borrower "out of the bank" (referred to below as a "forbearance scenario").

In the case of an amendment scenario, the borrower and its counsel will want to ensure that any and all past defaults have been irrevocably waived and that the newly amended covenants are sufficiently loose to permit the borrower to operate without restriction under the loan agreement under the circumstances then foreseeable. The more precarious the borrower's circumstances, the more likely it will be that the lender will insist on other concessions (such as a capital infusion to reduce the amount owed to the lender, higher amendment fees, *etc.*) so the borrower should be prepared for this possibility.

> Avoid having business owners give personal guaranties for loans.

In the forbearance scenario, the lender will probably have already decided to end the relationship. Thus, the lender's draft forbearance agreement will stipulate that various defaults have occurred and will provide that, notwithstanding such defaults, the lender, for a stated period, will forbear from exercising its remedies under the loan documents so long as no new events of default arise. This will afford the borrower time and a chance to refinance with another lender. In this case the borrower will have little or no negotiating leverage. Consequently, as a practical matter, all the borrower will be able to do (and it should certainly do all it can in this regard) is negotiate for as long a forbearance period as is possible and ensure that no other events of default occur under the loan documents.

> The borrower would be well-advised to anticipate issues before they become serious.

CONCLUSION

It is anybody's guess how long it will be (if ever) before we see conditions approaching those of the "boom years" preceding the Great Recession. In the meantime, however, the plight of the small-business borrower is by no means hopeless. Community banks need to make loans in order to survive, thus a business owner with a viable business and a willingness to be careful, disciplined and open in its dealings with its lender should be able to survive until the next upturn. WJ

NOTES

[1] Edward Gibbon, *The History of the Decline & Fall of the Roman Empire,* Vol. 12, Chap. LXVIII.

[2] *See* The Importance of Community Banking: A Conversation with Chairman Ben Bernanke, Community Banking Connections, Fed. Reserve System, Third Quarter 2012, at 1.

[3] Allen N. Berger and F. Udell, Gregory, 2002. *Small Business Credit Availability & Relationship Lending: The Importance of Bank Organizational Structure*, 112 Econ. J. 477 (2002), at 32-53.

[4] *See* generally John Martinez et al., *Viability of Community Banks in the Dallas Federal Reserve District: Evidence of Relationship & Transactional Orientation*, J. Applied Bus. Res., Second Quarter 2007, at 93-95.

[5] The Importance of Community Banking: A Conversation with Chairman Ben Bernanke, *supra* note 2, at 10; Arthur E. Wilmarth Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks,* 99 Iowa L. Rev. 957, 1039 (1992), at 65; William Keeton, The Role of Community Banks in the U.S. Economy, Econ. Rev., Fed. Reserve Bank of Kansas City (2003), at 24-25.

[6] Keeton, *supra* note 5, at 18-20.

[7] *Id.* at 20-26; The Importance of Community Banking: A Conversation with Chairman Ben Bernanke, *supra* note 2, at 10.

[8] The business should not take any comfort in the possibility that an imbalance of negotiating power could influence a court to invalidate the agreement as a contract of adhesion. This principle is seldom applied to contracts between businesses. *See PPM Fin. v. Norandal USA,* 297 F. Supp. 2d 1072 (N.D. Ill. 2004); *Mistry Prabhudas Mangi Eng. Pvt. v. Raytheon Engineers & Constructors,* 213 F. Supp. 2d 20, 27 (Mass. 2002).

[9] Note that courts tend to be averse to these kinds of provisions. *See Capitol Justice LLC v. Wachovia Bank N.A.,* 706 F. Supp. 2d 23 (D.D.C. 2009); *Langley v. Prudential Mortgage Capital Co.,* No. 07-cv-404-JMH, 2007 WL 4365423, at *4 (E.D. Ky. Dec. 12, 2007).

[10] As a general matter, a lender may secure a loan with a guaranty of a spouse of a business owner, but this principle is subject to the Equal Credit Opportunity Act, 15 U.S.C. §1691 (2012), and its accompanying regulations, which prohibit a lender from requiring a spouse's personal guarantee as a condition for a commercial loan to a business when the business or the businessperson qualifies for the loan. Violation of this rule could invalidate the guaranty. *See, e.g., Silverman v. Eastrich Multiple Investor Fund,* 51 F.3d 28, 33 (3d Cir. 1995). However, the regulations include a specific exception that permits lenders to obtain a spouse's signature where the lender reasonably believes the signature is necessary "under applicable state law to make the property being offered as security available to satisfy the debt in the event of default." 12 C.F.R. § 202.7(d)(2), (d)(4). The FDIC has explained that this exception would apply where spouses hold property by tenants in the entirety and where the lender relies on the jointly held property in extending credit. Financial Institution Letters, Fed. Deposit Ins. Corp. (Jan. 13, 2004), *available at* http://www.fdic.gov/news/news/financial/2004/fil0604a.html#ft7.