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THE SAN ANDREAS ECONOMY:

PROTECTING YOUR BUSINESS FROM THE INEVITABLE EARTHQUAKE

BY **JEFF WURST**

Thousands of Californian's persist in living on both sides of the San Andreas fault line, knowing that a major earthquake can send them tumbling into the sea. Jeff Wurst points out that some lenders live the same way — enjoying the current economic boom and ignoring the inevitable downturn on the horizon. His suggestions can help protect businesses when the boom falls.

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We are all aware of the San Andreas Fault that some say threatens the west coast of California. Common knowledge predicts that one good tremor around the fault will drop a slice of California into the sea. Regular tremors shake the area, and every so often there is a major earthquake. This year back to back quakes measured at or about 7.0 and there were hundreds of lesser reactions. Yet, Ob-La-Di life goes on and people continue to live near and west of the fault. They think, "The big one is not going to happen to me." Yet, logic has it that someday — despite all the warnings — people will get caught by surprise.

We have been living with a booming economy for more than 10 years. Still, we all know that what goes up will come down. The stock market continues to grow despite having some tremors of its own. Five hundred points in a day. Seven hundred points in a day. A thousand points in a day. Each time the market has fallen it has bounced back. Ob-La-Di life goes on, and people continue to remain invested. They think, "The big one is not going to happen to me." Yet, logic has it that someday – despite all the warnings – people will get caught by surprise.

The Great Depression commenced with the stock market crash on October 24, 1929, and continued at least through 1938. Although the Wall Street crash showed an initial drop in the Dow Jones Industrial Average of 12.8%, the market continued to slip to an 89% drop when it bottomed out in July, 1932. It took 25 years before the stock market returned to its September, 1929, level. Subsequent crashes (1987 and 2008) had quicker recoveries.

We may be prone to burying our heads in the sand and ignoring the risk of a major adjustment. Why not? It is so unpleasant to consider such concepts. But history does repeat itself and despite what we have learned from the past, we tend to make the same mistakes. Prudent lenders need to prepare themselves for a downside.

What can lenders (and even borrowers) do to get ready... just in case?

LEGAL REVIEW

Take a fresh look at your legal documents. Periodic legal reviews, although they may appear to be unnecessary, are cost effective even if they only save you from one problem. The fact is that over time your practices change, but they are not always reflected in your documents. Do you (or your servicing agent) have possession of original documents- especially promissory notes? Are the loan documents properly executed? Are there missing pages? Are there any patent errors? We once were asked to handle the workout of a loan that we had not documented and, in our legal review, we noticed that while the borrower was ABC Corp the granting clause read "XYZ grants lender a securing interest in and to…." You'd be surprised what kinds of errors can occur in the cut and paste world in which we live.

UCC FILINGS

Is your UCC filing correct? Did you file as CW Mining Company when the debtor's legal name is actually C.W. Mining Company? Or Silver Dollar LLC instead of Silver Dollar Stores, LLC? Or, did ABC Corp., a New York corporation reorganize and merge with and into ABC, LLC, a Delaware limited liability company and the borrower didn't think to tell you about it? Or was the UCC-1 securing General Motor's $1.5 Billion loan erroneously terminated when another secured facility was paid off? These types of nightmares happened to someone else. Don't let them happen to you. Is there now another secured party you did not know about? How about a pre-existing equipment lien that contained a hidden all asset filing?

TAX LIENS

Of course, you should be doing regular searches for tax liens, but do you? You need to.

VERIFICATIONS

Are you (or your servicing agent) performing regular verifications of accounts? Face it! There is fraud in your portfolio. You just haven't found it. It is not difficult to camouflage fraud during a strong economy such as the one we have been enjoying. But once a down-turn arrives, and you peel back the onion, you may be shocked at what you find. Diligent and regular verifications will help to identify these types of problems before they turn into a serious problem.

ACCOUNT DEBTORS

Are you monitoring your borrower's account debtors? Are they on reasonably sound ground? Are they on any watch list? Are they paying on time and consistent with prior history? If not, at least start with discussing this with your borrower.

APPRAISALS

Are they current? Are you comfortable that they were properly performed? Are you comfortable that in the event of a liquidation you will recover what the appraisal says you will recover? Is the appraised inventory reasonably turning around, or is it aging out? Is there still a market for all those expensive silk ties that no one wears any longer?

EXIT STRATEGY

Is it sound? Once, when we were re-documenting an existing loan to a concession of a major national department store chain, we pressed about the exit strategy. Lenders rarely share appraisals with their lawyers prior to a workout, and we had asked about the exit strategy during the initial loan documentation process only to be told that the very reputable appraiser had properly addressed that. We did get to see the appraiser's exit strategy during the re-documentation only to find that it called for going out-of-business sales. Fortunately, as part of the re-documentation we needed to revise the agreement with the department store chain that hosted the borrower's concession. We were able to negotiate a process whereby what we might consider to be a GOB sale could be affected in a seamless manner so as not to disturb the ordinary course of business at the department store. Fortunately, that process has not been needed. However, without those modifications to the agreement with the department store, a liquidation of the borrower's inventory in place would have not been possible.

REVIEW THE BORROWER'S BANK RECORDS

Since the advent of merchant cash advance providers, we are finding more and more incidents where borrowers have turned to MCAs to satisfy what they perceive to be short term additional cash needs. They do this without advising their lender out of fear that the lender will not permit it. As a result, it is becoming more and more common for lenders to discover that their borrowers' bank records show daily or weekly ACH transfers to MCAs, indicating that the borrowers' liquidity is not as it otherwise appeared.

Of course, this is just a short list of things lenders can do to mitigate potential risks in their portfolios. The point is, there are many key indicators that point to a down turn in the economy and, with that, we need to expect and prepare for softness in our loan portfolios. Now is the best time to take measure to minimize the risks.

Unlike those living within the reach of the San Andreas Fault who refuse to take measures to mitigate their risks, lenders need to prepare for a down turn in the economy and the effect it will have on their portfolios. Early preparation is the best way to ensure the success of you borrowers and your institution. •

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