NEFA
National Equipment Finance Association
NEWSLINE
JUL/AUG 2023

Preparing for a Downturn: Recommendations for Lenders & Lessors

Economic turbulence creates uncertainty for lenders and lessors. Lewis Cohn provides creditors a seven-point checklist to minimize risk and potential losses in both good times and bad.

By Lewis J. Cohn

Today's economic storm presents us with a number of challenges – elevated inflation and interest rates, a volatile stock market, an inverted yield curve, $1.5 trillion in student loan debt and endless geopolitical events.

Lewis J. Cohn
Cohn & Dussi LLC

As part of this stormy picture, debt balances in American households reached a record high of $17.05 trillion during the first quarter of 2023, rising $148 billion from the fourth quarter of 2022, according to a report from the Federal Reserve Bank of New York. These increases run the gamut, from mortgages and home equity lines of credit to auto loans and student loans to retail cards and other consumer loans.

Most of us have seen this movie before and know it concludes with a recession. The questions are when will we engage this next phase to recovery and will it be a hard or soft landing. We don't have the precise answers as to when and how abrupt it will be, but one view all creditors can agree on is we have to be prepared for every possible situation.

It is important for lenders and lessors to be prepared, not only at the bottom of an economic cycle but also during the robust years, knowing that the economy has its ups and downs. From a legal perspective, whether you underwrote deep and wide during strong economic times or stayed in your "lane," every creditor needs to consider this seven-point checklist to minimize risk and any potential losses over the coming months:

■ **Workouts:** Before going down the path of litigation to recover your money and collateral, it's best to partner with your customer and restructure your business relationship. Loan and lease modifications as well as forbearance agreements preserve the deal while pursuing the debt, and recovering your collateral may only force your client into bankruptcy. Often, perceived leverage cuts both ways. Most creditors have a workout group dedicated to partnering with the debtor, but when these arrangements fail to materialize in the early phase or break down after an agreement has been consummated, a law firm's letterhead and greeting can get your relationship back on track. Hence working with a creditors' rights specialist can make all the difference in avoiding a permanent loss.

■ **Documentation:** Turning to your contract, does it accurately reflect all liable parties such as the business entity and your personal guarantors? Does your system of record store the latest contact information? When your customer goes into default, having this information is paramount in firing up your pre-litigation workout strategy. On the flip side, if the default cannot be turned around, then knowing the liable parties will fast track the legal approach in pursuing your remedies. As a final point regarding your contract with the debtor, does your default covenant include the triggers that define a default such as non-payment, possession of title and lack of insurance? If you have multiple finance agreements are they cross collateralized and is there a cross default provision? A listing of all of your potential damages should also be defined to pave the way for a legal solution.

■ **Compliance:** In today's world, compliance at the state and federal level has a critical impact on your underwriting and the enforceability of your contract. You must ensure that your contract is enforceable in the states not only where you and your customer reside but also where your collateral is located. To get the right read on your exposures, any legal counsel you engage must be experienced in defending agreements, knowledgeable about the rules in all federal, state and local jurisdictions, and current on all relevant legislation. Do not underestimate the importance of knowing the judge in your jurisdiction. Time and time again, being aware of how the judge is likely to rule affects the way your case needs to be argued to be successful.

■ **UCCs:** If you have a security interest in collateral, then it's imperative that you file an accurate UCC-1 Finance Statement to alert the world that you own the collateral and so that, in the event of a default, you are a secured creditor with the right to foreclose on it. A UCC-1 is a legal notice filed by a creditor under the Uniform Commercial Code (UCC), a set of laws governing commercial transactions that has been adopted at least in part by all 50 states, as well as the District of Colum-

bia and other U.S. territories. A UCC-1 Finance Statement establishes the relative priority of specific assets, laying out which ones may be seized and in what order in case there are multiple lenders to the same debtor. Without this filing, you are considered to be an unsecured creditor and risk not being able to recover your assets. It's also worth noting that a UCC-1's life span is five years, and it needs to be renewed to avoid losing your position as a secured creditor. That renewal procedure is available as early as six months before the five-year anniversary. It goes without saying that if your customer undergoes a hardship or files bankruptcy, the UCC will preserve your rights.

■ **Venue Provision:** Most attorneys would agree that whether you're dealing with litigation or arbitration, select a venue that is most convenient for you with the customer bearing the cost and time associated with defending themselves. If the creditor has the proper venue language in their agreement, they have the flexibility as to whether they want to pursue the debtor in their own state or the state of the debtor. This strategy can reduce the time and cost associated with domesticating and executing a judgment or pursuing their equipment or secured assets. It's a strategy worth considering.

■ **Landlord Waiver:** On many occasions, there's more than two parties involved in a lease, and the third party may very well be a landlord whose tenant is the lessee. In the event that your customer goes into default, you always want the option of stepping onto the premises and recovering your equipment. To have that protection, you will need the landlord to sign a Landlord Waiver, also called a Subordination to Tenant's Lender's Security Interest. In the event the equipment is a fixture to the third-party rental space, such as cabinets, hard-wired restaurant equipment or automotive lifts, the removal of the equipment could pose a problem, unless there is a workaround in the waiver requiring the tenant to restore the space to its original condition. Overall if the creditor does not issue a waiver or subordination agreement, the lessor is exposed to the landlord's right to place a lien on personal property, including your equipment, if the tenant/lessee defaults on their real estate lease. Given that the landlord is giving up some rights, it's important to draft a fair waiver so you can cover any of your downside risk with repossession of your collateral.

> “Most of us have seen this movie before and know it concludes with a recession.

■ **Partner-Up:** As suggested earlier, it is worth teaming up with a law firm with experience in the equipment finance space and working with them on constructing a bullet-proof lease agreement that covers all of your downside risk and affords you an array of remedies. Also, a law firm that contributed to your agreement should be in a position to successfully represent you in a default situation using a variety of fee options, based on the effort to recover your money and collateral. In challenging times, performance-based contingency fee pricing models may be your best option.

Although this a short list from a legal perspective, implementing all of the above measures will strengthen your organization's ability to respond to whatever the economy presents us in terms of delinquencies and charge-offs. While the number of defaults may not change, it is important to know that you will at least be better equipped at controlling and reducing losses, and ultimately charge-offs.

ABOUT THE AUTHOR: Lewis J. Cohn is Managing Partner at Cohn & Dussi LLC.