

READING**LIQUIDATION**

In essence, liquidation is a quick route to collecting at least some of the debt and ending the bank's involvement with a problem loan. Although the most convenient solution, liquidation may not be the most effective way to minimize the bank's loss. Even if unsuccessful, most debtors appreciate an attempt at a loan workout. But quickly moving to liquidate collateral rarely evokes a customer's goodwill and may preclude any future relationship between bank and borrower, as well as friends or associates of the borrower, guarantors or other stakeholders. Once liquidation is pursued, it is difficult to reverse direction and attempt working with the borrower to rehabilitate the company.

Before proceeding to liquidate collateral, a business banker considers the bank's rights to collateral, the borrower's cooperation, and the collateral's value and marketability.

The bank's rights to collateral

The business banker or attorney for the bank carefully reviews loan documents to ensure the bank has a valid security interest. The failure to update a UCC-1 financing statement filing, an erroneous description, an improperly notarized mortgage or deed of trust, or an oversight in affixing a corporate seal can invalidate a bank's right to the collateral. Even if all documents are in order, liens, perfected purchase money security interests, or prior security positions held by other creditors can encumber collateral.

Borrower cooperation

Only with the borrower's full cooperation can liquidation proceed smoothly. Generally, efforts by the borrower to sell the collateral will yield more money than the bank would receive. An attempt to frustrate or to legally challenge efforts to locate and sell the collateral can cost the bank a considerable loss of time and money. In the absence of the debtor's cooperation, the business banker can expect efforts to foreclose on collateral will trigger a legal challenge. If so, the bank may become involved in protracted litigation, resulting in substantial legal and court costs.

Collateral value and marketability

Two important variables to consider are how easily the collateral can be liquidated and the amount of proceeds that can be realized from its sale. An environmental risk analysis, if appropriate for real estate and a liquidation value appraisal provide estimates of the collateral's worth. The business banker should also determine how long it will take to obtain proper title in order to sell the collateral.

The collateral's marketability is another consideration. Finding buyers for unfinished or work-in-process inventory or special purpose equipment may be difficult. Until it is sold, collateral is an unproductive asset for the bank. It may add considerable expense in taxes, insurance premiums, storage, and security costs. The other alternative, to sell the collateral as quickly as possible, probably will raise much less money than its appraised value.

Proceed with liquidation

Depending on the type of collateral and whether the debtor challenges the bank's rights to it, the bank can liquidate collateral in a variety of ways. The ideal arrangement is an out-of-court liquidation. If the effort is cooperative, both the bank and borrower benefit. Expensive legal proceedings are avoided, and the borrower may assist the bank in finding a buyer. The alternative, going to court to obtain a judgment against the debtor, can be a lengthy, frustrating experience that will certainly result in high attorney and court costs. Before moving to liquidate collateral, the business banker should consult with legal counsel. Foreclosure proceedings involve many legal decisions, and the active assistance of counsel is essential.

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Liquidating cash and securities—Under the terms of most loan documents, the bank is given the right of set-off, in which deposits in the borrower's banking accounts (checking, payroll, business CDs, and lockbox) can be applied against the amount owed on the debt. A set-off will exacerbate the business's cash flow problems, possibly triggering its failure. The bank should weigh the consequences of a possible bankruptcy against the risk of deferring action and allowing the borrower to withdraw funds.

Marketable securities offer several advantages, because they are relatively easy to foreclose, provided the bank has the correct and signed loan documents. Although Securities and Exchange Commission (SEC) requirements may restrict the sale of the securities to certain purchasers only, otherwise marketable securities usually sell easily. Unlike other types of collateral, their value is less likely to be disputed. When the bank holds securities as collateral, the lender should closely follow the value to determine if and when to demand payment from the borrower.

Liquidating accounts receivable, inventory, and equipment—The Uniform Commercial Code (UCC) governs procedures for foreclosing on accounts receivable, inventory, and equipment. The liquidation value of these assets can be difficult to determine

To liquidate accounts receivable, a business banker first obtains company business records, such as an aged listing of accounts receivable, to determine if accounts receivable can be collected. At this point, most of the good accounts receivable have been paid, and the lender often faces the prospect of trying to collect past due accounts.

Inventory includes raw materials, work-in-process and finished goods. Raw materials may be returned to suppliers or sold to other companies. Work-in-process inventory raises important questions—Should the work be completed? What is the cost to complete? Would the lending bank be the source of the funds? What is the value if completed? Usually, the borrower has sold much of the finished goods, and a portion of the remaining finished goods may be obsolete or otherwise not marketable.

Liquidating equipment generates challenges that include storage, costs to move, repairs, maintenance, and insurance. Perhaps the most important factor, though, is the debtor's willingness to cooperate. The bank can take possession either through voluntary surrender or a court judgment in its favor. A voluntary surrender is less costly and generally yields a higher return on sales, because the borrower may help by finding purchasers for the equipment.

Liquidating real estate—Because state laws govern real property foreclosure, liquidation procedures are not uniform nationally. When a loan is secured by real estate, a business banker should work closely with bank attorneys. Another potentially troublesome aspect is the valuation of real estate, which can vary depending on lease agreements, property location, and zoning. In any case, liquidating real estate usually is a lengthy process, often lasting a year or longer. An environmental survey can help determine if there is contamination or hazardous material at the site. A new appraisal often is needed to determine the current market value.