COMMERCIAL LENDING ALERT

KNOW YOUR BORROWER'S STRUCTURE

November 2006

Modern Business Structures

In today's business world the typical company has a multi-entity structure. This structure often consists of a holding company and numerous subsidiaries (which are usually wholly-owned corporations or single-member limited liability companies, or "LLC's"), or a series of entities owned by the same group of owners. Reasons for having such a structure include: limiting operating liabilities (such as product liability claims) to the specific business and shielding other business segments from liability; fashioning incentive compensation for employees working in particular business segments; limiting state taxation; and dealing with union and non-union business settings.

On the other hand, owners want the outside world – suppliers, customers and financers – to determine to do business with their organization on the basis of the financial strength of entire organizations as a whole.

Lenders' Concerns

Enter the commercial lender. The business owner wants the lender to consider the assets and business activities of all segments when making the determination to make financing available. The owner also wants to be able to direct loan proceeds to the entity within the organization that needs the funds, even if that entity itself does not have asset values that would support the loan.

The lender, however, should be concerned about the bankruptcy dangers (e.g., fraudulent conveyance) of making a loan to an asset-poor subsidiary guaranteed by all other related entities, which have pledged their assets to secure all loan advances but which do not get the benefit of the loan advances to their weaker affiliate. As a result of such concern, many lenders make separate advances to each entity of an affiliated group based on such entity's asset values and take other actions (beyond the scope of this Alert) to minimize the bankruptcy risks.

Dealing with the Borrower's Structure

Aside from bankruptcy concerns, the broader concern is that the lender must *understand* its borrower's structure in order to be sure that all entities within the borrower's affiliated group are obligated under the loan agreements, notes, security agreements and guarantees. For example:

- Does the borrower simply have divisions (often using distinct trade names) but not separate subsidiaries or "brother-sister" entities?

- Are the borrower's separate business segments corporations or limited liability companies (wholly-owned, single member limited liability companies are easily formed and generally have no federal income tax implications)?

- Do the entities have common ownership (brother-sister companies)?

In addition to requiring potential borrowers to furnish copies of all organizational documents for all group entities, the lender should consider searching the official records of the state under which each entity is purportedly organized and requiring each entity to deliver comprehensive resolutions clearly authorizing the proposed loans and pledges of collateral. Resolutions should be signed by all directors of each corporation and all members (and managers, if the LLC is manager-managed) of each LLC. Regarding LLC's, the resolutions should also state that the resolutions supersede

any conflicting provision of the LLC's operating agreement and constitute an amendment to the operating agreement because of the frequent difficulty in determining what members or managers are authorized to bind the LLC solely from a reading of the LLC's operating agreement.

The lender should also require the borrower to represent and warrant its exact organizational structure and to agree not to change the structure without prior notice to the lender.

Recent Example

A recent Missouri case highlights the perils of not carefully taking into account a multi-entity organizational structure. In Healthstyle Products International v. Union Planters Bank, 193 S.W. 3d 330 (Mo. App. E.D. 2006), two corporations with the same owners and the same officers obtained separate secured loans from the same lender at two different times, and each corporation pledged its own assets to secure only its own loan. Corporation 2 subsequently signed an amendment to its loan agreement stating that all agreements (including security interest grants) extended to and covered the loans to both Corporation 1 and Corporation 2.

After Corporation 2 defaulted on its loan, the lender attempted to obtain repayment of Corporation 2's loan in part by foreclosing on a brokerage account owned by Corporation 1 and pledged to the lender to secure Corporation 1's loan. Corporation 1 filed suit against the lender alleging that Corporation 1 was a separate entity and therefore not obligated under any document signed only by Corporation 2. The brokerage company interpleaded the funds in the account and paid the funds into court. Although the trial court granted the lender's motion for summary judgment (ruling that the account secured the loans to both entities), the court of appeals reversed the ruling and held that the purported loan amendment was a contract answering for the debts of another and therefore must be in writing and signed by the obligor. Here, the persons who were the principals of *both* corporations signed the amendment but only under the corporate name of Corporation 2. Therefore, the court held, the amendment did not obligate Corporation 1 even though the persons signing were officers of both corporations.

Conclusion

The lessons for the commercial lender: Know, and keep current on, your borrower's organizational structure and treat each subsidiary and affiliated company as a separate "person." Failing to do so could have unfortunate results.

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