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Collateral Descriptions and Blanket Liens

By Barbara M. Goodstein

Blanket or "all-assets" security interests are among the most common, if not *the* most common, type of lien required of borrowers by secured lenders in commercial transactions. Describing the collateral for an all-assets lien intuitively might seem easy. However, getting collateral descriptions correct under the rules of Article 9 of the Uniform Commercial Code (UCC) has challenged secured lenders for decades, and all-assets liens are no exception. Two recent bankruptcy court decisions illustrate these challenges. In particular, they reflect the importance of distinguishing between a blanket lien collateral description in a security agreement and one in a UCC financing statement.

Background

Under Article 9, in order to create and perfect a security interest on most collateral, a secured creditor must provide a collateral description.

UCC § 9-203 states that a security interest attaches and becomes enforceable by a secured creditor against a debtor and third parties if: 1) value has been given; 2) the debtor has rights in the collateral or the power to transfer rights in the collateral; and 3) there is evidence of the parties' intent to create a security interest. The third condition has been described as an evidentiary requirement in the nature of a Statute of Frauds, seeking to both avoid litigation of claims based on oral agreements and minimize disputes as to what was agreed. *See In re Numeric*, 485 F.2d 1328, 1331 (1st Cir. 1973); *see also* U.C.C. § 9-108, cmt. 2 and U.C.C. § 9-203, cmt. 3.

In most cases, the third requirement is satisfied when the debtor has "authenticated" (*See* U.C.C.§ 9-102(a)(7)) a security agreement containing a description of the collateral. U.C.C. § 9-203(b)(3)(A). Note that for certain types of assets, such as deposit accounts, investment property and electronic chattel paper, possession or "control" is sufficient to evidence the parties' agreement without the need for a collateral description. *See* U.C.C. §§ 9-203(b)(3)(B), (C) and (D).

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Good News, Bad News: Credit and Collections

Looking at the Big Picture

By Brett Boehm

The robust economy's low default rate has many creditors rethinking their collections practices and capabilities. But what should be their strategy for when the good times end?

Since emerging from the recession in 2009, lenders have enjoyed a nearly unprecedented opportunity to add new deals to their portfolios of loans and leases. Meeting the recovering and expanding demands for equipment has meant financing opportunities have been abundant.

While at face value, an expanding economy is almost always a cause for celebration, lenders today are finding today's strong growth can present its own unique challenges. Many are finding trends developing that must be recognized and planned for now — before the inevitable change in the business climate occurs.

I had the privilege of meeting face-to-face with about 150 senior credit and collections executives recently in Washington, DC, while attending and serving as a moderator for two panel sessions at the Equipment Leasing and Finance Association (ELFA) annual Credit and Collections Management Conference. The conference was an eye opener for me, revealing current

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But what constitutes a sufficient description of the collateral? UCC § 9-108(a) contains the general rule, which is that a description is sufficient if it "reasonably identifies" the collateral. Subsection (b) states that a collateral description reasonably identifies the collateral if it uses any of the following methods: 1) specific listing; 2) category; 3) type of collateral defined in Article 9 (such as "accounts," "goods," "general intangibles" and the like); 4) quantity; 5) computational or allocational formula or procedure; or 6) any other method by which the identity of the collateral is objectively determinable. Note, while a specific listing is one way to reasonably identify the collateral, the other methods make it clear that reasonable identification of the collateral does not mean that the description must be detailed. *See* U.C.C. § 9-108, cmt. 2.

Article 9 specifically rejects a broad, supergeneric "all assets" or "all personal property" security agreement description as insufficient, stating in § 9-108(c) that a description such as "all of the debtor's assets" or "all of the debtor's personal property" or words of similar import does not reasonably identify collateral.

In addition, a separate collateral description is required if a UCC financing statement will be filed to "perfect" the security interest on collateral. Under UCC § 9-502(a), a UCC financing statement must include the following in order to perfect a security interest: 1) name of the debtor; 2) name of the secured party or a representative of the secured party; and 3) indication of the collateral covered by the UCC financing statement. Note, to be effective, a UCC financing statement also needs to be authorized by the debtor. U.C.C. §§ 9-509 and 9-510(a). For certain special types of UCC financing statements, other items need to be included as well, such as information about related real property in the case of a fixture filing. U.C.C. § 9-502(b).

In direct contrast to the rules governing a security agreement collateral description, the rules for the third essential component of a UCC financing statement, the "indication" of the collateral, are simple, limited and liberal. UCC § 9-504 states that a financing statement "sufficiently indicates" the collateral if it either describes the collateral in a manner that satisfies UCC § 9-108 (in other words, a description that "reasonably identifies" the collateral for purposes of a security agreement will suffice for a financing statement) or indicates it covers "all assets" or "all personal property." UCC § 9-506(a) goes even further by stating that a financing statement with errors and omissions is still sufficient, unless those errors and omissions make it seriously misleading.

This more forgiving standard for the indication of collateral in a UCC financing statement derives from the limited nature and different purpose of a UCC financing statement. Such a statement is intended simply to give public notice that a person may have a security interest in the collateral indicated, on the assumption that the searcher can then seek more information from the debtor or secured party. *See* U.C.C. §9-502 cmt. 2. As compared with a security agreement, it does not need to satisfy evidentiary requirements as to the intent of the parties.

Accordingly, a collateral description that "reasonably identifies" collateral for purposes of a security agreement will also serve to sufficiently "indicate" the collateral for purposes of a UCC financing statement. The reverse, however, is not true. When counsel is not mindful of these distinctions, there can be negative consequences, as illustrated by the two cases discussed below.

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DE Dealer Statute Only Covers New Equipment

By Adam J. Schlagman and Gina Passarella

Suppliers only have to repurchase new, unused equipment from dealers under Delaware's Equipment Dealer Contracts Statute, the state Supreme Court has ruled in answering a question certified from the Third Circuit.

The en banc court's decision in *Terex v. Southern Track & Pump*, No. 13-4279 (June 16), ruled that the statute's silence on the suppliers' obligations to repurchase used equipment when a distributor agreement was terminated meant there was no obligation to repurchase the used inventory.

The conflict arose from two seemingly contradictory portions of the statute, with distributor Southern Track & Pump (Southern Track) arguing that the statute provided for the repurchase of "all inventory," while *Terex* highlighted the fact that the statute's subsequent pricing formulas for repurchase only referenced unused equipment.

Facts

Southern Track, a Florida-based equipment dealership that sells and leases construction equipment, entered into a distributorship agreement with Terex Corporation (Terex), a Delaware corporation that manufactures construction equipment. Pursuant to a distributorship agreement governed by Delaware law, Southern Track purchased from Terex approximately $4 million worth of equipment (about 40 pieces in total) and $50,000 worth of parts. Southern Track financed its purchase through an arrangement with GE Commercial Distribution Finance Company (GE). The financing was secured by the equipment Southern Track purchased from Terex, using funds provided by GE.

Due to marketing difficulties, Southern Track's loan obligations to GE became too onerous and Southern Track decided to terminate the distributorship agreement. In its termination letter, Southern Track indicated that it wanted to keep some equipment, but it wanted Terex to repurchase everything else because Southern Track assumed that the Dealer Statute's repurchase obligation would force Terex to repurchase all of the unwanted inventory. Terex, of course, disagreed, contending that the Dealer Statute required a supplier to repurchase only new and unused equipment and because most of the equipment Terex sold to Southern Track had entered Southern Track's rental fleet, the equipment was now used.

Consequently, Terex asked Southern Track to compile a list of the new and unused equipment Southern Track had in its inventory. Instead of complying with this request, Southern Track sent Terex a letter indentifying 17 pieces of equipment that it wanted Terex "to come and pick up." Over half of those items had been in operational use for 175 to 300 hours. Yet Southern Track insisted that Terex was required to purchase the equipment at brand new prices.

Terex offered to repurchase nine of the 17 pieces of equipment and offered to pay market value for the equipment, but reserved the right to take a deduction for any parts or repair services "required to return any of the repurchased equipment to good running and operating condition."

Southern Track, under increasing pressure from GE to make past-due payments or risk losing possession of the equipment, filed a declaratory judgment action against Terex in the Delaware Superior Court. One day later — and one month before the expiration of the Dealer Statute's 90-day repurchase period — GE took possession of all of the equipment Southern Track had purchased from Terex. GE later sold most of this equipment at auction.

The District Court

Terex removed the lawsuit to the United States District Court for the District of Delaware. In Southern Track's second amended complaint, it alleged that Terex had violated the Dealer Statute when it failed to repurchase "all inventory previously purchased [from it] … that remain[ed] unsold on the date of the termination of the agreement." As a result of the alleged breach, Southern Track claimed that it was entitled to the relief prescribed by § 2727(a) of the Dealer Statute, namely, that Terex was "civilly liable for 100% of the 'current net price' of the inventory" plus other associated costs and fees.

The parties filed cross-motions for summary judgment in the district court. The issue before the court was whether a supplier's repurchase obligation under § 2723(a) extends to all inventory in a dealer's possession that remains unsold, or only applies to inventory that remains in new and unused condition.

The court held that § 2723(a) required suppliers to repurchase all — not just new and unused — inventory. The court ruled that Terex's actions ran afoul of the Dealer Statute because Terex offered to repurchase only the new and unused equipment. The district court granted Southern Track's motion for summary judgment, and ordered Terex to pay the full price of all inventory it had sold to Southern Track that remained unsold on the date of the termination of the distributorship agreement (which amounted to approximately $4.35 million).

Terex appealed the district court's judgment to the The U.S. Court of Appeals for the Third Circuit, which certified the issue.

The DE Supreme Court's Ruling

The Delaware Supreme Court disagreed in an opinion by Justice Karen L. Valihura. The court found

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Adam J. Schlagman is Editor-in-Chief of this newsletter. This article is an updated and expanded version of one written by **Gina Passarella** that appeared in the *Delaware Law Weekly*, an ALM sister publication of this newsletter.

DE Dealer Statute

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that the district court had judicially filled a statutory gap by creating the negotiated-price formula with no support from the legislation.

"We conclude that a supplier's repurchase obligation under the dealer statute is limited to new, unused, undamaged and complete inventory, consistent with the statutory scheme, the canon of avoiding unnecessary statutory gap-filling, and our preference to avoid interpretations that could invite constitutional entanglements," Valihura said.

She noted in her opinion that the dealer statute was designed to level the uneven playing field between suppliers of equipment and the dealers or distributors of that equipment. As a result of superior bargaining power, suppliers typically require a minimum purchase obligation, putting dealers in a tough spot of having a lot of inventory in sometimes difficult business climates, Valihura said.

The dealer statute requires that the seller repurchase the dealer's inventory within 90 days from the date that a distribution contract agreement is terminated unless the dealer chooses to keep the inventory, according to the opinion. The court acknowledged, however, that "all inventory" in Section 2723(a) of the statute can be read in two ways. Southern Track & Pump said "all" means "all" in looking for a declaratory judgment that Terex had to repurchase all of the $4 million in inventory Southern Track & Pump purchased from Terex. Southern Track & Pump said any other reading would render the word "all" superfluous.

But Terex looked to Section 2723(b), which states that the supplier shall pay the dealer 100% of the cost of all "'new, unused, undamaged and complete inventory,'" and 85% of the current net price of new repair parts.

Valihura pointed to the detail the legislature put into the statute, suggesting it was intentionally silent on used inventory.

"A requirement that used equipment must also be repurchased would be a matter of fundamental significance in this statutory scheme," Valihura said. "It is inconsistent with the statute's overall level of detail to infer by the legislature's silence that it intended to require the repurchase of used equipment."

The Third Circuit characterized Delaware's dealer statute as unique from those in other states, Valihura said. Other states expressly address a price formula for repurchasing used equipment, she said.

As for the meaning of the term "all" before inventory, Valihura said that term meant the supplier had to repurchase all of the inventory that was statutorily required to be repurchased and not just a subset of that. So a supplier must repurchase all of the new, unused equipment, not just some of it.

Valihura said that the Supreme Court's ruling avoids having to reach the question of whether the statute is punitive or presents an unconstitutional taking. Terex had argued that it would be an unconstitutional taking for it to be required to repurchase used products at like-new prices, she said. The statute's only penalty for the supplier, aside from some costs, is repayment at current value if the inventory is not repurchased within the 90 days.

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Judicial Decisions

Two recent bankruptcy court decisions emphasize the need for counsel to be aware of the distinctions between the rules for collateral descriptions in security agreements and those for financing statements.

In re Hintze

In the February 2015 Florida bankruptcy case of *In re Hintze*, 525 B.R. 780 (Bankr. N.D. Fla. Feb. 11, 2015), the debtors, Matthew and Larina Hintze, had delivered a promissory note, which contained a security interest grant, to creditor Christopher James. The grant read as follows: "As security for payment of the principal, interest and other sums due under this note, Maker hereby grants to Holder a security interest in all of Maker's assets." (In the Note, "Maker" meant the debtors.) About 19 months after the note was signed, a UCC-1 financing statement was filed with the Florida Secretary of State against the debtors, describing the collateral as "All personal property owned by the Debtors, including cash or cash equivalents, stocks, bonds, mutual funds, certificates of deposit, household goods and furnishings, automobiles and water craft." *Id.* at 782.

The creditor had objected to the proposed sale of certain membership interests by the debtors' trustee in bankruptcy, claiming, among other things, that he had the right to credit bid based on his lien on such assets.

The trustee asserted that the collateral description was legally insufficient and that therefore the creditor was unsecured. The creditor, in turn, argued that summary judgment was not appropriate because the intent of the parties governed, and insisted that the court take parol evidence on the meaning of the collateral description.

Judge Karen K. Specie granted a motion for summary judgment by the trustee, finding that the collateral description in a security agreement of "all of Maker's assets" was insufficient as a matter of law to create a security interest.

The judge rejected the creditor's argument that a supergeneric collateral description was permissible by virtue of Official Comment 2 to UCC § 9-108, which states that the "purpose of requiring a description of collateral in a security agreement under § 9-203 is evidentiary." Not surprisingly, the judge found that argument unpersuasive, given the

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express statement in 9-108(c) that an all assets description is not sufficient to reasonably identify collateral. The court also rejected the creditor's attempt to introduce parol evidence, stating that reliance on parol evidence is contrary to the "purpose and effect of the UCC" and that the UCC in fact discourages parol evidence. *Id*. at 788. However, note that White and Summers support the use of parol evidence in interpreting collateral descriptions in security interest grants. *See* their discussion of the collateral description rules in their treatise, Uniform Commercial Code, 6th ed., 2010, v.4, § 31-3.b.

The creditor also invoked the somewhat less supergeneric collateral description that appeared in the related UCC filing. The creditor argued that the court should apply a composite documents approach that some courts have used to look to both the collateral description in the security interest grant and the collateral description in the UCC filing, to remedy the defect in the security interest grant collateral description. *Id*. But the court declined to do so here, noting that there is no support for combining the language in the note with a UCC financing statement filed 19 months later. *Id*. at 791.

Ring v. First Niagara Bank

The more relaxed standard for UCC financing statement collateral descriptions was applied in *Ring v. First Niagara Bank, N.A.* (*In re Sterling United*), 519 B.R. 586 (Bankr. W.D.N.Y. 2014), to uphold the creditor's perfected security interest against a challenge by the bankruptcy trustee.

In the Western District of New York *Sterling United* bankruptcy case, again in the context of a motion for summary judgment, Judge Michael J. Kaplan considered the rules for collateral descriptions in UCC financing statements. At issue in that case was what Kaplan characterized as a "needlessly convoluted" description of collateral in a succession of UCC financing statement filings. *Id*. at 588.

In that case, it was undisputed that First Niagara Bank had been granted an all assets security interest by the debtor, a printing business, under the security agreement. *Id*. Note, the decision does not describe the collateral description in the documents granting the security interest to the bank, but states that it was not disputed that the bank properly took a security interest in all assets of the debtor.

The bank's early financing statements in 2005, 2006 and 2007 described the collateral as:

> All assets of the Debtor including, but not limited to, any and all equipment, fixtures, inventory, accounts, chattel paper, documents, instruments, investment property, general intangibles, letter-of-credit rights and deposit accounts now owned and hereafter acquired by Debtor and located at or relating to the operation of the premises at 100 River Rock Drive, Suite 304, Buffalo, New York, together with any products and proceeds thereof including but not limited to, a certain Komori 628 P & L Ten Color Press and Heidelberg B20 Folder and Prism Print Management System.

The debtor subsequently changed its name and moved to Amherst, New York. While the bank amended the UCC filing to reflect the name change and change of address, it did not amend the UCC collateral description (which continued to refer to the old address) until February 2013, when it amended the collateral description to read as follows:

> All assets of the Debtor including, but not limited to, any and all equipment, fixtures, inventory, accounts, chattel paper, documents, instruments, investment property, general intangibles, letter-of-credit rights and deposit accounts now owned and hereafter acquired by Debtor, including but not limited to those located at or relating to the operation of the premises at 6030 N. Bailey Avenue, Amherst, New York 14226, together with any products and proceeds thereof.

Unfortunately for the bank, an involuntary Chapter 7 petition was filed against the debtor in May 2013, within 90 days of the filing of that amended collateral description. Accordingly, the bankruptcy trustee sought to avoid the bank's security interest as unperfected due to a defective collateral description.

The trustee in bankruptcy in this case claimed not that the description didn't sufficiently indicate the collateral, but rather that the description was "seriously misleading" under 9-506. Kaplan rejected the assertion that the appropriate standard in assessing the adequacy of the collateral description, given the ambiguity, was whether any hypothetical creditor could have been misled. Instead he found that a standard of "reasonableness" or "prudence" on the part of a searcher is appropriate. *Id*. at 591. Kaplan emphasized that, under existing case law, when the collateral description is ambiguous (which he assumed to be the case here), the purpose of a notice filing (*i.e.*, UCC financing statement filing) is to indicate the creditor may have a security interest in the collateral, and merely is the starting point for investigation by another creditor. *Id*.

CONCLUSION

The above cases illustrate what can happen when practitioners act almost in counterpoint to the requirements of the collateral description rules. The succinct "all of Maker's assets" language in *Hintze* could easily have provided sufficient notice for a financing statement description; unfortunately it was used for a security interest grant. On the other hand, the *Sterling United* description added verbosity where it was clearly not needed, the result being it gave rise to uncertainty and needless litigation.

Commentators have puzzled over the reasoning behind the UCC Article 9 prohibition on supergeneric collateral descriptions in security

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interest grants. *See, e.g., White & Summers*, *supra* note 9 at 122-23. The Official Comments say simply that this follows prevailing case law. *See* U.C.C. § 9-108, cmt. 2. However, the evidentiary purpose of a security agreement grant, as compared to the broad and basic notice function of a UCC financing statement, would seem to provide significant justification for the differences in approach.

As noted above, drafting an effective "all personal property" collateral description for a security interest grant requires close attention to UCC § 9-108(b), which provides safe harbors for what constitutes a reasonable, and therefore sufficient, description of most items of collateral. For example, § 9-108(b)(3) sanctions descriptions using UCC-defined "types" of collateral. But, as with many Article 9 provisions, there are exceptions to even that safe harbor. Notably, a security interest grant in a commercial tort claim must contain a "descriptive component beyond the 'type' alone" (U.C.C. § 9-108(e)) and requires commercial tort claims to be described in a security agreement with "greater specificity" than is required for most other types of collateral. U.C.C. § 9-108, cmt. 5. Similarly, a description of collateral by type alone is insufficient for a grant of a security interest in a consumer transaction on consumer goods, a security entitlement, security account or commodity account. U.C.C. §9-108(e). The New York U.C.C. also provides that a description by type is insufficient for a cooperative interest. *See* N.Y.U.C.C. Law § 9-108(e)(3) (McKinney 2001).

All of the above underscores the need for practitioners to be familiar with and sensitive to the differences in the rules governing collateral descriptions, and mindful as to whether such description is being relied upon in order to create, or instead to perfect, a security interest.

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Credit, Collections

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strategies and emerging best management practices that are being adopted by creditors. The three-day event provided a great opportunity for me to get a better understanding of the issues and potential concerns within the lending community.

Even in a period of unprecedented opportunity and growth for creditors, I learned, steps must be taken to prepare for a change in today's lending climate.

Beware of Complacency

One question many creditors are asking is: How do we stay ahead of the curve in credit and collections management, even with an uptick in new business volume? Is the real danger less that the current economy will slow and more that complacency today is preventing us from preparing for that slowdown?

Brett Boehm is a principal of TBF Financial, LLC, which serves the equipment leasing and finance industry by purchasing portfolios of charged-off small-ticket leases and loans to help individual companies recover cash quickly and improve their account balances. The Deerfield, IL-based firm is an active member of the ELFA, and Boehm has served on its Credit and Collections Planning Committee since 2012.

I recall that at last year's ELFA credit management conference, everyone was talking about regulation and the uncertainties surrounding the long-pending changes to lease accounting rules. What a difference a year makes — especially a year of very strong leasing and lending opportunities. This year, regulation was not the primary focus. Everyone, it seemed, had dealt with the regulation issues that were affecting their portfolios and resolved them. Instead, the most prominent topic seemed to be the strength of the recovery and the quality and quantity of deals being inked.

But beneath this celebration was the realization that success almost always presents its own unique risks for failure. Many I spoke with felt that the most reckless approach is not taking the time to evaluate those risks and plan for them.

If the consensus was that business seems to be booming again and increases in new businesses are at an all-time high, there was far less agreement on what this might mean. Are defaults going to pick up? Is there another recession in sight? How should creditors plan for the inevitable change from the current business climate?

Optimism remains high among lenders. No one argued that another visible recession is in sight, although many admitted they had never experienced a period like that they've seen since 2009. The sentiment seems to be that the current climate is just part of a cycle, and we are moving through it. New business is continuing to materialize, and charge-offs are at an all-time low — under 1%, according to economist Beth Ann Bovino, the U.S. chief economist at Standard & Poor's Ratings Services, based in New York, and a presenter at the conference.

So, with charge-offs at an all-time low, why should lenders be worried?

Understanding How We Got Here

Savvy creditors know that an end to the current strong business climate is inevitable. And this means that defaults should be increasing in 2016, 2017, and going forward. The reasons for this are based on a cycle that most lenders are well familiar with. Those who have been through

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a downturn know and understand it fully.

To understand it, let's take a quick look at how we got to where we are today.

First, during the 2007 through 2008 downturn, lenders cleaned off their books. Faced with ever-growing numbers of defaults and increasingly futile collections efforts on their mounting delinquent accounts, many creditors ended up just charging them off. In the best of cases, it was a pragmatic approach to the then-current climate; in the worst cases, there really were no other viable options.

While there were a lot of charge-offs in 2008 and 2009, and even headed into 20010, most lenders' books were cleaned up or almost cleaned up by then. During that period when the economy was in a nose-dive, businesses were failing and certainly weren't looking for new equipment. People weren't starting new businesses, either, so there weren't startups or entrepreneurs looking for new equipment. Moreover, the companies that were surviving were just holding on, so they weren't looking to lease or buy new equipment.

Should anyone have been out and about looking for new equipment back in 2009 or 2010, they would have needed very strong credit before any finance company was going to lend to them because creditors were still reeling from what they had just experienced with so many charge-offs and so much bad debt.

When lenders weren't putting the usual quantity of new deals on their books and the deals they were booking had A+ credit, they knew that eventually there weren't going to be charge-offs on the portion of them that would end up as bad debts. Again, savvy creditors understand that you need a steady flow of new business to see the inevitable fall-off on the back side. So that's what happened: Charge-offs plummeted simply because so few new leases and loans had been written during the downturn and the ones written were solid.

At my company, which is focused specifically on buying charged-off leases and loans, we saw first-hand that the writing was on the wall and knew that this was a cyclical phenomenon. With the default rate dropping, we started to buy all the charge-offs we could because we knew we needed to expand our business right then, at that optimal point in the cycle. We knew charge-off rates were destined to plummet with the low volume of new equipment lease business being conducted.

I'm glad we acted while there was still an opportunity. Defaults and their subsequent charge-off rates have been under 1% since about 2010. That's five years of an all-time low rate for charge-offs.

Which Way Out?

The path out of the last downturn has been relatively easy to see for those lenders who have been down it before. Many at the conference who have experienced previous recession cycles recognized a familiar pattern reappearing — once the bottom had been hit.

Over the past several years, once lenders got comfortable again and felt they needed to add new deals and the economy started to improve, businesses saw opportunities and became entrepreneurial again. It's a simple truth that growing businesses need equipment, and they're willing to invest in it in order to continue to grow their business and generate revenue. In meeting this demand, it didn't take long for leasing companies to start getting business back on their books again.

And with this new influx of business came the foundation for the predictable uptick in defaults that we are just now starting to see.

Yes, it has taken a while, but today, lenders and lessors have gotten back on their books the quantity of business they had before the downturn. If they've got a five-year lease, when would an obligation that old necessarily go into default? Not quickly, in most instances. Consequently, it's been taking time to churn through all the new business that's been booked since 2009 to where it's soon going to be seen in the rate of charge-offs. Will it be a year or two before the uptick in defaults really becomes apparent? As far as projections, no one really knows, but Beth-Ann Bovino did show conference attendees data indicating there's an increase underway already.

Now, some people will say, "Uh oh, there's an increase in charge-offs. That's bad, right?" But overall, the feeling is it's not necessarily bad; it's just the natural result of a certain percentage of the unusually large volume of new business falling into default.

Gaining Perspective

When creditors sign the large volume of new lease or loan business they've seen since 2009, they're surely going to generate a certain volume of delinquent accounts that end up being charged off. Even though it might look scary to have any rate of charge-off, even under 1%, an average charge-off rate back in the day was 2% to 3%. Think about it: That's a 200% to 300% *increase* over what it is now.

The truth is, if leasing companies have a 3% charge-off rate, this means *97% of their overall portfolio is performing well*. That's a tremendous success rate when you look at the big picture. Remember, 3% is a very small percentage to have charged off, but it's still a substantial portion of business that needs to be dealt with by the work-out department or, eventually, for some companies, sold to companies like mine that buy charged-off paper. The bottom line is that leasing companies can still be thriving tremendously with a 3% charge-off rate because 97% of their portfolio is still performing successfully.

For the most part over the years, it has been the die-hard, hangers-on businesses, the ones that applied for and obtained credit, that kept

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Credit, Collections

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funders active because their lease or loan approval rate has been exceptionally high as well. Does that mean that lenders are loaning to pretty much anyone who applies? Or is it that the stronger companies are the ones that have survived and are still around to merit and receive funding?

It appears to be that the stronger companies are the ones that are applying for equipment leases, and now, as the economy continues to get better and down-trodden companies re-establish their footing, find their niche, and get entrepreneurial again, lenders are going to have more new businesses to fund. In addition, maybe companies that are not as strong but suddenly are feeling more confident in their businesses and their need for new equipment will be applying, as well. This scenario may bring down the overall loan or lease approval rate a little bit, but it will get things back to normal — or at least to where it was when times were good and everyone was happy.

While the prospect of rising charge-off rates should not necessarily be a cause for alarm among lenders, being unprepared for it could be.

Bolstering Collections Capability

Conference attendees learned about the results of a proprietary survey TBF Financial conducted on behalf of the ELFA regarding collections departments within leasing companies. TBF surveyed them starting in 2009 and was able to track developments in their collections efforts as the recession receded. Given the overall decline in the number of charge-offs, many leasing companies were finding their in-house collections departments underutilized and unprofitable. In many instances, personnel and resources in these departments were being reallocated — if not cut altogether. The ELFA wanted to know what percentage of leasing companies were maintaining their in-house collections capabilities. Were they adding staff? Were they having a hard time collecting? Were they using their collections department to generate additional income?

TBF's survey covered a wide array of leasing companies with collections capabilities. Not surprisingly, most of the respondents were banks, primarily focused on small-ticket leases. Participants were split approximately 50/50 between captives and independents.

Respondents were asked to list the default rate of their portfolios. They were then asked to provide their collections success rate, which proved to still be very low. Some 20% of survey respondents said they had a 1% to 5% increase in core collections over the past year. But one of the more interesting observations from the survey was that many respondents admitted having a difficult time hiring new people, and they were often unimpressed by the candidates they did find for their collections positions. A common sentiment was that collections departments are not perceived as "sexy," and the overall impression of the collections field is not a good one. Apparently, candidates for collections work do not perceive it as a stepping stone or a great place to start in finance.

But the most surprising discovery TBF made is that, despite the recognition that defaults are expected to increase, a majority of companies were *not* committed to adding more personnel or resources to their collections department. Instead, they apparently plan to do more with less staff. Survey respondents admitted they were concerned that their collections capabilities will not be prepared to deal with a rise in defaults that will end up as charge-offs. Many have resigned themselves to the notion they'll be scrambling and will just have to deal with it.

The survey also revealed that recoveries are at an all-time high. In the 30-to-60-day timeframe, ELFA data show the default rate is up, but leasing companies end up collecting on most of those accounts because companies are increasingly allowing their accounts to go into default. While it used to be standard practice that accounts that were past due by 15 days were immediately contacted so they didn't hit the 30-day mark, leasing companies now are letting their lessees hit that 30-day mark, calling them on day 31, and telling them they're late and must pay a late fee. This strategy has been successful for many companies in generating late-fee revenue via collections. Even though the 30-day default rate is up, almost all accounts are getting collected within 90 days, keeping the overall charge-off rate under 1%.

Certainly, no one at the conference could predict when our current period of unprecedented opportunity and growth for creditors might slow, end, or change direction altogether. But the savviest lenders seem to recognize this uncertainty and are taking steps to minimize the risk associated with the inevitable change in today's lending climate.

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