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Lenders Yanking Borrowers' Bucks

BANKING: Financiers cut off funding for projects under way.

By Alex HYLAND *Staff Reporter*

Banks have been tightening their lending standards for months amid the credit crisis and worsening economy. Now, borrowers have a new worry: losing loans they thought they had locked in – or even have already accessed.

Earlier this month, local startup 60Frames Entertainment Corp. and Newport Beach real estate developer Betek Corp. filed lawsuits in Los Angeles Superior Court claiming banks had breached loan contracts in an attempt to minimize their risks.

In Betek's case, it claims Pasadena-based East West Bank suspended its access to a $16-million loan that was financing a 30-unit condominium building near Koreatown that had been under construction for months.

Industry analysts said banks are looking to backpedal on deals that months ago looked good but don't now because of the souring economy.

"Because of the financial meltdown, a lot of institutions, banks in particular, have been trying to recapitalize their balance sheets," said James Barth, a Milken Institute financial institution and capital market analyst. "And they do that by cutting back on loans they are making and pulling back on some existing lines of credit."

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311 Gramercy Place: Construction loan by East West Bank.

The Los Angeles Superior Court lawsuits were filed amid a flurry of similar actions nationwide as borrowers, including billionaire developer Donald Trump, allege banks are going to extreme tactics to renege on existing loan agreement.

The lawsuits, especially those brought by developers, generally have a common theme: Banks are claiming that substantial changes – so-called "material adverse changes" – give them the right to walk away from a loan or rewrite loan agreements.

Lloyd Greif, president of Los Angeles investment bank Greif & Co., said there is no doubt banks are scrutinizing current loan agreements for clauses that will enable them to either pull back on existing lines of credit or alter the loan requirements.

"They are reading the fine print to see if they can find a reasonable or justifiable way out – a loophole that they can make a gap big enough through which to drive a mack truck consisting of material adverse change provisions," said Greif. "You are going to see a torrent of these cases as banks scramble to get out of deals that in 20/20 hindsight they shouldn't have gotten into."

The lawsuits are generating notoriety because banks traditionally have not invoked material adverse change clauses except in such extreme events as the Sept. 11 terrorist attacks.

John Black, chief executive of 1st Enterprise Bank, said widespread enforcement of material adverse change provisions was last triggered about eight years ago.

"The most significant prior event would have been the tech collapse that occurred in 2000," Black said.

'Standard clause'

More commonly, the provision is triggered in specific, isolated cases, such as when a borrower encounters a big financial setback from some unrelated problem. But the clause can be invoked whenever a bank believes that certain occurrences or events are likely to cause a long-term decrease in a borrower's financial condition.

"It is a standard clause where a material change in the financial condition of the borrower allows an event of default," said Mark Neubauer, a litigator in the L.A. office of Steptoe & Johnson LLP.

60Frames Entertainment is a Los Angeles startup that produces and distributes online content of new actors. It obtained a $1 million loan from Dallas-based Comerica Bank in July. The company planned to use the money for general operating expenses until it raised money from investors in September, according to the lawsuit.

However, the company claims that in October Comerica sent a letter demanding 60Frames begin maintaining at least $800,000 cash in a collateral account, of which the bank could freeze up to $750,000.

Bryan Freedman, the company's attorney, said 60Frames refused to agree to the additional loan requirement, prompting Comerica to declare the $1 million loan in default even though the company agreed to provide detailed financials showing that it was solvent. The bank cited the loan agreement's material adverse change clause.

"After the credit crisis started, and for no other reason, Comerica sent a letter saying we want you to hold $800,000 in the account and not use it at all," Freedman said. "They did it because they wanted to limit their downside risk."

Comerica declined comment on the lawsuit.

In the case of real estate developer Betek, which is constructing a condo building at 311 Gramercy Place, the company claims East West suspended new drawdowns on a $16-million construction loan, saying the credit crisis had devalued the condo project, which was serving as the loan's collateral.

The condo project is already in the framing stage, and the company claims that the bank's action has prevented it from completing the installation of weatherproofing and roofing in advance of the rainy season.

Betek said in its lawsuit that the loan suspension took place even though construction was progressing on schedule, and the company invested $8 million of its own money in the project in accordance with the loan agreement.

Betek's lawyer declined to comment on the pending litigation, as did East West.

Working out

Not all banks are simply turning to material adverse change provisions as a means to walk away from loan agreements.

1st Century Bancshares Inc., the L.A.-based parent of 1st Century Bank, has not cited the clause recently with loan customers that it is concerned may be financially unstable, said Alan Rothenberg, the bank's chief executive.

"If the loan is due on Dec. 31, and if you force the issue, you put undue pressure on the client that hurts their business," Rothenberg said. "When you could sit down, and say 'Let's work out term payments over the next 24 months,' that gives you breathing room to grow and build the business."

However, he acknowledged that some of his colleagues in the banking industry are taking a different approach to risky loans on their books.

"In general, I don't think there is any bank that wants to do anything except work with the borrower, (but) there is a fair amount of hunkering down," he said, "amid circumstances in which covenants and other agreements that might have been ignored or not enforced in the past are being enforced much more closely."