CAPITAL NOTES

NEWS ABOUT THE FINANCIAL & LEGAL MARKETS
FROM CAPITAL FINANCE

"EXPERIENCE, EXPERTISE, INTEGRITY AND CLARITY"

July, 2008

Happy July 4th!

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Deepening Insolvency Theory Gains Traction

Although not as broad in its application as "good faith and fair dealing," the theory of deepening insolvency as a cause of action related to lender liability is being used and accepted more. What is deepening insolvency anyway?

Deepening insolvency usually refers to a lender renewing or extending new debt to a borrower whose future prospects for financial success are in doubt. This theory is strengthened in cases where the lender takes additional collateral or improves its legal position at the same time.

In the past, such cases were usually brought by the creditors committee of a bankrupt debtor; claiming the lender had kept the debtor "alive" to improve the lender's position at the expense of other creditors or to avoid a preference. Recent cases have expanded to actions brought by borrowers and shareholders.

Importantly, more courts are recognizing this theory of lender liability. To be sure, some questions still exist. When does a borrower enter the "zone of insolvency?" As in other lender liability cases, much of the outcome depends the individual circumstances as well as the lender's adherence to the "10 Rules for Avoiding Lender Liability." If you find yourself involved in or have questions about such a dispute, feel free to call us.

Credit Markets Tight…er

In our last newsletter we commented on the tight conditions in the credit markets. The sub-prime crisis has had a spillover effect into other markets. Construction and mortgage loans are difficult to obtain. Credit card and equity lines of credit are being cancelled or reduced. There are three primary reasons.

Bank capital ratios have been so eroded due to portfolio losses in consumer real estate loans (and their derivatives) that banks are reluctant to commit new capital even to good borrowers. New extensions of credit cause a decline in the lender's capital-to-assets ratio which, in the current climate, tends to hurt rather than help the lender assuming the capital is available.

Underwriting standards and procedures are getting a hard look. The sub-prime debacle has highlighted the risks in trying to take shortcuts when approving any kind of loan. Lenders are going back to basics on every type of credit extension including derivatives. The esoteric instruments created in recent years with credit enhancements, securitization, credit default swaps, mark to model (read myth), and insurance have proven that lenders can't repeal the laws of economics.

Too, regulators are clamping down hard on any institution they perceive to be a candidate for "prompt corrective action." Given current economic conditions and the domino effect of the real estate crash, lenders are beefing up reserves for possible loan losses. There is a natural time lag between economic downturns and actual charge offs. Regulators are expected to take a very conservative view of loan portfolios and lenders know this. Any lender perceived as unable to weather the storm will get slapped with orders to improve; further exacerbating their problems. To avoid this downward spiral, good lenders are in "bunker mentality."

All this adds up to a very tough environment if you need to borrow. As always, if Capital Finance can help, give us a call.