

Five Litigation Risks Facing Special Assets Officers in 2027

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This is the first article in a three-part series examining the litigation risks lenders face as commercial loan defaults rise and lessons from recent cases that can help lenders strengthen their recovery position. Brought to you by the team behind our Banking On It blog.

We are operating in an environment of elevated economic uncertainty. Rising interest rates, persistent inflation in key sectors, and tightening credit conditions have driven a significant increase in commercial loan defaults. For special assets officers and workout professionals, the volume and complexity of distressed credits in the pipeline are at levels we have not seen in years. This environment produces a consistent blind spot: many lenders focus almost exclusively on credit risk while overlooking litigation risk.

This can be a costly oversight. The most significant lender liabilities often do not arise from the original underwriting decision. Rather, they arise from actions taken (or not taken) after default. The decisions made during the first 90 days of a credit workout often determine the outcome of future litigation and whether that litigation takes the form of a borrower's counterclaim, a bankruptcy preference action, or a lender liability suit. Understanding where those risks concentrate is the first step toward managing them effectively. The five risks discussed below are among the most common and, if not addressed early, can have a significant impact on the lender's position in a later dispute. Subsequent posts in this series will address the critical window for lenders before a Chapter 11 filing and draw lessons from some of the major crypto bankruptcies in recent years.

Risk 1: Informal Workout Communications

One commonly underestimated risk involves communications that occur during early workout discussions. When a loan enters special assets, there is an understandable urgency to resolve the situation quickly. Loan officers pick up the phone, send emails, and engage in conversations that, while seemingly informal, may carry enormous

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legal significance.

Every email sent during a workout is a potential trial exhibit and may become a focus in deposition. Oral promises, even casual reassurances about forbearance or restructuring, can create evidentiary hurdles if a borrower later claims reliance on those statements. Perhaps most dangerous are inconsistent communications, where different members of the lending team convey contradictory messages about the bank's intentions or the borrower's options.

A practical way to mitigate these risks is to centralize all borrower communications through a designated point of contact and develop litigation-conscious workout protocols from the outset. Documentation standards should require that every substantive communication be reduced to writing, that oral conversations be memorialized promptly, and that all communications be reviewed for consistency before they are sent. While treating every workout communication as potential evidence may seem overly cautious, it is sound risk management that may reduce future litigation exposure.

Risk 2: Failure to Perfect or Protect Collateral

A lender's collateral is only as valuable as its ability to enforce its security interest, and that ability depends on proper perfection and ongoing maintenance. In the rush of day-to-day lending operations, Uniform Commercial Code (UCC) perfection issues can slip through the cracks. Filing deadlines are missed, continuation statements are not timely filed, and lapsed liens create priority disputes that could cost a lender its entire recovery.

These issues become acute in a restructuring context. When a loan is amended or collateral is substituted, the perfection analysis must be revisited from the ground up. Guaranties should be reviewed to confirm they remain enforceable and have not been inadvertently released by amendment activity. Security interests in new collateral must be properly documented and perfected.

Lenders should conduct regular collateral audits — not just at origination, but on an ongoing basis and particularly at the outset of

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any workout. As part of each audit, lenders should review UCC filings, confirm that continuation statements are current, and reevaluate perfection after every restructuring event. A lien that was properly perfected five years ago may no longer be effective today, and discovering that deficiency in the middle of a bankruptcy proceeding can be fatal to recovery.

Risk 3: Borrower Fraud and Misrepresentation Claims

Financial distress can reveal fraud and misrepresentations that previously went undetected. Financial statement manipulation is common: borrowers may overstate revenues, understate liabilities, or conceal contingent obligations. Hidden liabilities, undisclosed related-party transactions, and insider transfers of assets are recurring themes in distressed credit situations.

The challenge for lenders is that this conduct is often not discovered until the borrower is already in default and the damage has been done. Early forensic review is critical. At the first sign of financial distress, lenders should engage forensic accountants to conduct an independent analysis of the borrower's financial condition. Evidence preservation should be an immediate priority, particularly electronic communications and financial records that may be lost, altered, or destroyed as conditions deteriorate.

Enhanced diligence on distressed credits means going beyond the financial statements the borrower provides. It means independently verifying asset values, conducting lien searches, reviewing public filings, and investigating the borrower's relationships with insiders and affiliates. This early forensic work can help identify issues before they become costly surprises.

Risk 4: Bankruptcy Filing Risks

A borrower's bankruptcy filing transforms the lender's position overnight. The automatic stay halts all collection activity. Preference exposure puts payments received in the 90 days before filing at risk of clawback. Cash collateral disputes can freeze the lender's access to the very assets securing its loan.

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These risks rarely arise without warning; they are often foreseeable consequences of a borrower's deteriorating financial condition. The lender that waits for a bankruptcy filing to begin thinking about bankruptcy strategy is already behind. Before a filing occurs, lenders should identify all critical collateral and assess its vulnerability in bankruptcy. Legal and credit teams should coordinate to develop a litigation strategy that anticipates the most likely bankruptcy scenarios, including adequate protection motions, cash collateral stipulations, and preference defense preparation.

Developing a bankruptcy strategy before the filing also means understanding the lender's exposure to preference liability and taking steps to minimize it. Documenting the ordinary course of business, contemporaneous exchange, and new value defenses well in advance of any filing is far more effective than trying to reconstruct that evidence after a trustee's demand letter arrives.

Risk 5: Lender Liability Counterclaims

The final risk on this list is also the one most likely to transform a straightforward collection action into protracted and expensive litigation. Lender liability counterclaims, whether based on allegations of bad-faith lending, improper workout conduct, or breach of fiduciary duty, are an increasingly common response to enforcement actions. Borrowers facing collection will scrutinize every aspect of the lender's conduct, searching for any basis to portray the lender as the wrongdoer.

The best defense against lender liability claims is conduct that can withstand scrutiny. When a borrower relationship moves toward workout or bankruptcy, the following best practices can help lenders limit their liability exposure:

- Maintain arm's-length relationships with borrowers, even (or perhaps especially) when longstanding banking relationships make that feel uncomfortable.
- Document the business reasons for every significant decision, including why a waiver was granted, why additional advances were made or denied, and why particular workout terms were proposed.

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- Involve experienced counsel early in the workout process, before communications and decisions create a record that is difficult to explain later.

Courts evaluating lender liability claims look at the totality of the lender's conduct. A consistent record of reasonable, well-documented decisions is the strongest shield against allegations that the lender acted in bad faith.

Key Takeaway

The best litigation strategy begins before litigation exists. Special assets officers who treat distressed loans as potential litigation matters from the moment of default — and who centralize communications, audit collateral, investigate fraud, prepare for bankruptcy, and guard against lender liability exposure — will consistently achieve better outcomes than those who focus solely on credit resolution and hope that litigation never materializes.

In the current environment, focusing solely on credit risk while overlooking litigation risk is a luxury that lenders cannot afford. The decisions made at the outset of a credit workout often determine the outcome of future litigation, and those decisions deserve the same rigor and attention as the original credit approval process.

Early action gives lenders the most options. If your institution is managing a distressed credit or anticipating a workout, please contact the author or any member of the firm's Regional & Community Banks team to discuss ways to protect collateral and manage litigation risk.

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