Know Your Borrower… And Your Borrower's Business

Amundsen Davis Financial Services Alert
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With the adoption of the Patriot Act in 2001, many of us became familiar with the concept of "knowing your customer." Among other things, the Patriot Act required United States financial institutions to create and adhere to customer identification programs which were designed to detect and discourage money laundering through the use of banks. As a result of the process, many institutions learn a great deal about their customers at the inception of any relationship, whether it is a depository relationship or a borrowing relationship. But what do you know about your customer's business?

Most lenders utilize a standard form to ask customers for information when a customer is interested in obtaining credit, whether consumer or commercial. A commercial lending officer will typically prepare a memorandum with supporting documentation for review by an internal credit committee. That report may include information such as the type of business, projections for operating the business (if it's a new area or a complete start-up), as well as information about the officers and directors associated with the venture. Additionally, any well written credit memorandum should include an assessment of the potential borrower's compliance with various regulatory and legal guidelines. For example, if the borrower operates a chain of liquor stores, it is essential that the bank determine whether the borrower possess the requisite license and insurance to operate its business. The borrower may have the most creative ideas for marketing and sale of its products; however, it won't get very far without the appropriate regulatory approvals. Most jurisdictions have zoning regulations which authorize or prohibit the operation of certain types of businesses in restricted areas. For example, Indiana law prohibits the sale of alcoholic beverages within so many feet of a school or a place of worship. If your institution is considering a loan to a restaurant which will include the sale of alcoholic beverages, a lending officer would be advised to ensure that the potential customer has obtained the appropriate zoning authorization to operate the restaurant at its chosen location or locations.

The Indiana Court of Appeals is currently considering a case which may turn on the customer's compliance with zoning regulations. In the case of *Himsel v. Himsel*, a farmer and his two sons sought and obtained a zoning variance to accommodate a confined feeding operation in Hendricks County, Indiana. After the farming operation began, local landowners sued the farmer alleging that the hog farm constitutes a common law nuisance and had devalued their property.

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Martha Reddy Lehman
Partner

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The farmer, joined by regulatory authorities, other farming interests, and the Indiana Bankers Association, have argued that the farmers legally obtained a zoning variance, as well as a construction permit for the operation of the hog farm. Since there were no timely appeals from any of the approval decisions, the farmer asserts that the local landowners may not complain about the hog farm. During the loan process, the farmer accurately represented to the lender that there were no appeals filed challenging any of the zoning or permitting processes, and that the time periods for such appeals had expired. From the record at the trial court, it appears that the lender relied on these approvals and made a substantial line of credit available for the construction of the farm's facilities.

This case is a reminder of the need to not only understand your customer's origin but also your customer's business. In making the loan, a lender typically understands the risks as well as the rewards associated with a customer's business. As part of the "checklist" involved in making the loan, a lender should inquire about any specific legal or regulatory approvals required in order for the customer to engage in business. These can include zoning approvals as well as items such as background checks for employees, minimum insurance requirements, and licensure for employees. The complete list of potential requirements is beyond the scope of this article; however, your customer can and should know about these requirements. A prudent lender asks the right questions at the inception of the lending relationship. This assists the borrower in the implementation of the business while also assisting the lender in making a proper credit decision. Knowing your customer may be the law, but knowing your customer's business is equally important.