Commercial Loan Workouts: Forbearance Options and Waivers After Default
Crafting Forbearance Agreements and Correcting Loan Deficiencies to Strengthen the Lender's Position

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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The conference begins at:
1 pm Eastern
12 pm Central
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Correcting Deficiencies in Loan Documentation and Collateral 
Pre-Workout Due Diligence

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A. Review/Understand:

- Borrower’s business/causes of financial distress.
- Borrower’s obligations under all loan documents (notes, amendments, and security agreements).
- Loan status and nature of defaults (payment vs. covenant).
- Potential defenses/counterclaims (written correspondence with the borrower).
A. Review /Understand:

- Lender’s course of dealings with the borrower on past defaults - has there been history of waivers of defaults or course of dealing contrary to the loan terms.

- Borrower’s revenue sources.

- Borrower’s financials and tax returns.

- Borrower’s other key creditors and critical vendors.
A. Review/Understand:

- Nature and extent of all pledged collateral (mortgage, UCC-1s, rent assignments, accounts, receivables, inventory reports).
- Location of all collateral.
- Value of collateral according to appraisals/reports.
B. Search/Investigate/Update Information

- UCC-1 search on borrower and guarantors.
- Review borrower’s debts to key creditors and vendors.
- Property record searches for borrower and guarantor(s), potential guarantors.
- Determine whether lender has received PMSI notices.
- Update title search on mortgaged real estate.
B. Search/Investigate/Update Information

- Obtain updated rent rolls from borrower (mortgaged property).
- Obtain leases, determine landlord’s lien issues.
- Conduct public records search for judgments and tax liens (borrower and guarantors).
- Determine whether all security interests are properly perfected.
- Determine which collateral is subject to competing liens.
C. Analyze Collateral/Repayment Sources

- Review existing real estate appraisals.
- Update appraisals using qualified expert appraiser.
- Analyze rent rolls.
- Request financial reports and information called for in loan documents from borrower.
- Request updated financial statements from borrower.
C. Analyze Collateral/Repayment Sources

- Obtain/analyze borrowers’ accounts receivable.
- On-site audits of inventory, equipment and other hard collateral at borrower’s locations.
- Evaluate risk of dissipation and loss of collateral.
- Develop/implement plan to monitor collateral subject to dissipation during workout process.
- Determine existence of potential additional collateral.
D. Deposit Accounts/Control Agreements

• No perfection by filing, control required under UCC §9-401.
• Request statements from borrower reflecting all depository accounts (bank accounts, funds, securities).
• Determine who has access to accounts.
• Transfers of accounts to lender (to permit set-off).
D. Deposit Accounts/Control Agreements

- Accounts at other institutions.
- Require lender approval of disbursements.
- Review existing tri-party control agreements with borrower and other financial institutions.
- Must permit lender to direct disposition of funds in account without borrower’s consent.
D. Deposit Accounts/Control Agreements

• Springing vs. non-springing controls agreements.

• Determine notice requirements of lender to depository to stop borrower instructions.

• Consider locking down accounts to give lender immediate control.
E. Guaranties/Additional Collateral

- Consider obtaining new guaranties in exchange for forbearance.
- Review updated financial statements for existing guarantors.
- Public records search for guarantor property and liens.
- Determine what additional collateral may be requested from borrower/guarantors.
F. Landlord Waivers

- Borrower operations at leased locations.
- UCC § 9-3011(2) defers to state law rules on priority of landlord’s possessory liens for rent vs. UCC liens.
- Review state law statutes for creation/enforcement of landlord’s liens.
- Determine collateral subject to landlord’s liens.
- Seek waiver of landlord’s liens.
G. UCC Foreclosures

- Secured party may take possession of collateral with or without judicial process under UCC §9-609
- Whether or not to retake – factors:
  - Will debtor surrender without breach of peace?
  - Does debtor need collateral to operate?
  - What is collateral value in forced sale?
  - Sale in vs. out of ordinary course of business.
G. UCC Foreclosures

• Whether or not to retake – factors:
  o What is risk of collateral waste/dissipation?
  o Will debtor participate in orderly sale?
  o Will debtor agree to strict monitoring/direct payment to lender of proceeds?
  o If required, cost of judicial repossession (replevin).
G. UCC Foreclosures

• Lenders’ duties as to repossessed collateral:
  o Sale or disposition of collateral must be commercially reasonable.
  o Notice of sale required to borrower, guarantors, other parties with interest in collateral UCC §9-613.
  o Public vs. private sale.
  o Debtor’s right to redeem collateral.
H. Reservation of Rights Letter ("Preworkout") Agreement

• Written agreement to enter workout negotiations.

• Acknowledge loan documents.

• Acknowledge defaults, insecurity, other reasons for loan modification or forbearance discussions.

• Parties intend to engage in settlement negotiations.
H. Reservation of Rights letter (“Preworkout”) Agreement

• Content of settlement negotiations will be privileged and inadmissible in any state, federal or bankruptcy proceeding.
• Participation in negotiations will not be deemed waiver of any right under loan documents or used against lender for any purpose.
• No communications binding or usable against either party.
• No modification of loan documents unless and until formal written modification agreement executed.
H. Reservations of Rights Letter ("Preworkout") Agreement

- Participation in settlement negotiations shall not prejudice the lender in any manner, or create any defenses in the event of subsequent litigation or bankruptcy.
- If negotiations result in an agreement acceptable to both parties, formal, written loan modification agreement will be executed setting forth the terms.
- Lender maintains all rights provided under existing loan documents as if the negotiations did not occur unless written modification is signed.
Forbearance Agreements

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Premise: Often, the most effective action a creditor can take to collect a debt is to refrain from initiating a lawsuit.

Reasons:

- Litigation entails risk, expense and delay, and is often the precursor to a bankruptcy petition, with its resultant complications.
- Options are available that can preserve an ongoing relationship between the debtor and creditor.
- A consensual workout can reduce the amount of management time diverted from operations, eliminate substantial administrative expenses and preserve asset values for the benefit of both the creditor and debtor.
Whether to Enter into a Consensual Workout Involves a Multiple Step Analysis

- **First**, the creditor must evaluate the strength of its legal position. *(What is the anticipated outcome of the foreclosure effort.)*

- **Second**, the creditor should calculate the “transaction costs” associated with litigation. These costs may take several forms:
  - litigation expenses,
  - the time value of money, and
  - any tax consequences of litigation.

- **Third**, the creditor should be assessing the value of any assets pledged, both on an “as-is” and stabilized basis, as well as the collectability of any deficiency judgment obtained.
Recommended Provisions For Workout Agreements

If the economics of the transaction justify a consensual workout, the accord should be memorialized in a written workout or forbearance agreement.
1. Borrower’s Acknowledgment of the Obligation and Default

- One of the objectives of a workout agreement is to eliminate areas of dispute. If the forbearance agreement fails, it needs to contain recitals which ensure that any subsequent collection efforts proceed as efficiently as possible.

- Borrower should acknowledge:
  - gross loan balance, including:
    - the principal balance;
    - all accrued interest;
    - late charges;
    - miscellaneous expenses.
  - existence of contractual defaults.
2. Borrower Must Waive and Release Claims Against the Lender

- This is true, whether or not such claims have been raised or otherwise articulated to the Lender.

- Borrowers Acknowledgment. In consideration of the agreement of Lender to extend the time for payment of the principal indebtedness evidenced by the Note and secured by the Mortgage, Borrower hereby acknowledges that Borrower has no defense, offset or counterclaim to the payment of said principal, interest, fees and charges or any other indebtedness evidenced by such Note and secured by such Mortgage, and hereby knowingly and voluntarily waives and relinquishes any such defense, offset of counterclaim to the extent any such defense, offset or counterclaim may exist.
3. Lender’s Reservation of Rights

- The lender will want to reserve its rights against responsible third parties, such as co-makers, endorsers or guarantors.

- **Reservation of Rights Against Third Parties.** This Agreement is made on the express condition that it shall not be construed as precluding lender or any successors or assigns, from enforcing any rights against any person liable on the obligation secured as maker, endorser, guarantor, or otherwise, whose written consent hereto has not been obtained, for which purpose such debt may be treated as overdue and collected immediately in accordance with the terms of the Note as if this Agreement had not been made.
4. Borrower and Guarantor Should Ratify the Agreements

- The borrower should ratify the original loan and security agreement, and the guarantor should consent to the work-out agreement.

- **Ratification.** Each of the undersigned hereby consents to the terms and conditions of Lender’s agreement to extend and forbear pursuant to the terms of the certain Forbearance Agreement and Amendment to Loan and Security Agreement dated as of [date] by and between [creditor and debtor] (the “Forbearance Agreement”) and agrees that their respective obligations, as the case may be, with respect to any obligations to Lender under the Forbearance Agreement and Continuing Individual Guaranty, shall not be impaired, modified, changed, released, discharged or otherwise affected and that said Forbearance Agreement and Continuing Individual Guaranty are hereby ratified and reaffirmed and remain in full force and effect.
5. Lender Not Waiving Rights and Remedies

- By entering into a workout or forbearance agreement, it should be made clear that the Lender is not waiving its rights or remedies under law or equity.

- Rights and Remedies. This Agreement in no way constitutes a waiver of the Bank’s rights and remedies at law or in equity or as provided for in the Loan Documents. In the event that the Borrower and/or the Guarantor fail to comply with the terms and conditions hereof, the Bank’s agreement to forbear and any other agreements and covenants of the Bank hereunder shall immediately and automatically terminate without any obligation of the Bank to give the Borrower or the Guarantor any notice thereof and the Bank may at any time exercise its rights and remedies at law or in equity and as provided for in the Loan Documents. Except as to the Bank’s agreement to forbear pursuant to the terms of this Agreement, all provisions of the Loan Documents shall remain in full force and effect.
6. Bankruptcy Waiver

- Can a borrower waive its right to declare bankruptcy?
- Can the automatic stay be waived by a borrower?
  - Some courts have ruled that pre-bankruptcy waivers of the automatic stay of §362 are unenforceable.
    - Such waivers are invalid due to the debtor’s lack of capacity to act on behalf of the debtor-in-possession;
    - Such waivers are unenforceable under specific provisions of the Bankruptcy Code which limit the effectiveness of certain contractual provisions that take effect upon the filing of the bankruptcy case; and
    - Such waivers are extinguished by the Bankruptcy Code which abrogates the freedom to contract around its essential provisions.
  - Some courts enforce contractual waivers of the automatic stay.
    - A pre-petition waiver of bankruptcy benefits may be binding unless the agreement was obtained by coercion, fraud or a mutual mistake of material fact.
    - Such waivers are not self-executing and are not binding on third parties.
Commercial Loan Workouts: Forbearance Options and Waivers After Default

Minimizing Bankruptcy and Foreclosure Risks

Craig S. Unterberg

April 1, 2010

This material does not constitute a legal opinion or advice related to any of the subjects or topics mentioned herein. It is only an informative overview of the subject matter.
Minimizing Bankruptcy and Foreclosure Risks
Overview of Topics

- **Fraudulent Conveyances**
  - addressing potential fraudulent conveyance issues when obtaining additional credit protection in connection with a forbearance agreement or a waiver

- **Preferences**
  - assessing the risk of a preference action if the borrower subsequently files for bankruptcy

- **Lender Liability**
  - analyzing potential liability issues for a lender in connection with forbearance agreements and waivers

- **Intercreditor Agreements**
  - addressing the impact of intercreditor agreements on waivers and forbearance agreements
Minimizing Bankruptcy and Foreclosure Risks
Waiver and Forbearance Agreements After Default

Sample Requirements by Lenders in a Forbearance Agreement

- reduction in the facility size
- payment of waiver or amendment fees
- fix errors or deficiencies in perfection of collateral
- increase in interest rates and fees
- additional credit support (e.g., additional collateral (if available), personal guarantors, “bad boy” guarantees, etc.)
- prohibition of, or restrictions on the borrower’s ability to make, certain types of payments (e.g., management fees, dividends, stock repurchases, prepayment of indebtedness, payments on subordinated debt, etc.)
- further restrictions on other actions (e.g., incurrence of otherwise permitted debt)
- additional collateral restrictions (e.g., establishing lockbox arrangements)
- more frequent or additional financial information and collateral reporting
- engagement by the borrower of a restructuring officer or engagement by the lender (at the borrower’s expense) of financial or other consultants
- release by the borrower of the lenders from any claims
Minimizing Bankruptcy and Foreclosure Risks
Fraudulent Conveyances - Generally

Overview Fraudulent Conveyances Actions and Forbearance Agreements

- Lenders need to be aware of fraudulent conveyance risks when negotiating for additional credit protections in connection with a forbearance agreement.
- A fraudulent conveyance is the fraudulent “transfer” of property.
- The term “transfer” encompasses every mode of parting with an asset or interest in an asset, including the payment of money and the creation of a lien.
- Examples of a “transfer”
  - Taking new collateral
  - Curing a defect in perfection
  - Guaranteeing an obligation
- Fraudulent conveyance actions may be brought under state law or under federal law in a Bankruptcy.

Effect of Fraudulent Conveyance

- Set aside transfer
- Judgment for value of transferred asset
- Other relief as required by the circumstance
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Fraudulent Conveyances – State Law

Basic Overview of Fraudulent Conveyance Laws

• State law
  • the summary below is a general overview of laws on fraudulent conveyances, but the specific rules and provisions for each state may vary and will need to be verified based on the states relevant to the transaction.
  • Uniform Fraudulent Transfer Act (UFTA)
  • Uniform Fraudulent Conveyance Act (UFCA)
• under state law, there are typically two types of fraudulent conveyance actions:
  • actual (or intentional) fraudulent transfers
  • constructive fraudulent transfers
Minimizing Bankruptcy and Foreclosure Risks

Fraudulent Conveyances

State Law – Actual (Intentional)

State Law

- Actual (Intentional) Fraudulent Transfer
  - actual intent to hinder, delay or defraud any creditor of the debtor
  - examples of facts that may be considered (badges of fraud):
    - transfer or obligation was to an insider
    - debtor retained possession or control of the property transferred after the transfer
    - transfer or obligation was concealed
    - transfer was of substantially all the debtor’s assets
    - debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred
  - limitation period varies from state to state (usually between 4 and 6 years)
Minimizing Bankruptcy and Foreclosure Risks
Fraudulent Conveyances
State Law - Constructive

State Law
(cont’d)

• **Constructive Fraudulent Transfer**
  • there is no requirement to show “intent” to commit fraud

• **Elements**
  • transfer is less than “reasonably equivalent value”; and
  • the transferor:
    • was insolvent or rendered insolvent by the transfer,
    • intended to incur or believed it would incur debts beyond the transferor’s ability to pay as they matured, or
    • was engaged in business or a transaction, or was about to engage in business or a transaction, that left transferor with unreasonably small capital.
  • limitation period varies from state to state (usually between 4 and 6 years)
Minimizing Bankruptcy and Foreclosure Risks
Fraudulent Conveyances
Bankruptcy Code Section 548

**Federal law (Bankruptcy Code Section 548)**

- a trustee or debtor-in-possession (or other parties if authorized by the court) may avoid any transfer of property of the debtor or obligation incurred by the debtor if the debtor:
  - made the transfer or incurred the obligation with actual intent to hinder, delay or defraud present or future creditors; or
  - received less than reasonably equivalent value in exchange and
    - was insolvent at the time of or rendered insolvent as a result of the transaction, or
    - was left with unreasonably insufficient capital after the transaction, or
    - intended to incur or believed it would incur debts it would not be able to pay as such debts matured
  - if avoided, property may be recovered, or judgment may be awarded for value of property against transferor or transferee
  - 2 year limitations period
How to Determine “Reasonably Equivalent Value”

- Bankruptcy Code Section 548 does not define “reasonably equivalent value”

- A minority of courts have adopted a *per se* rule
  - the transfer of an interest in collateral to secure an antecedent debt constitutes a transfer for reasonably equivalent value
  - the value of the collateral is therefore irrelevant since the collateral only secures the amount of the debt

- A majority of courts have employed a fact-driven analysis
  - analyze facts to determine whether reasonably equivalent value has been given in exchange for collateral securing antecedent debt

  - these courts typically:
    - compared the value of the collateral transferred by the debtor to the value received by the debtor for the transfer; or
    - compared the value of the collateral transferred by the debtor to the amount of the antecedent debt
Minimizing Bankruptcy and Foreclosure Risks
Fraudulent Conveyance
Reasonably Equivalent Value – Summary

Summary of Fraudulent Conveyance Actions and Forbearance Agreements and Waivers

• When requiring new credit protections (or fixing errors in the perfection of prior credit protections) in connection with a forbearance agreement and waiver:
  
  • analyze applicable state laws on fraudulent conveyance issues
  
  • analyze “reasonable equivalent value” in connection with the granting by debtor or guarantors of the additional credit protections

• Note: consider impact of a “bad boy” guaranty to decrease the risks of a bankruptcy
Overview of Preferences and Forbearance Agreements and Waiver

- certain benefits gained by lender through a forbearance agreement may be subject to attack as preferences in a bankruptcy
- applies to unsecured creditors and under-secured creditors
- applies only when borrower has declared bankruptcy

Elements
- transfer of an interest of the debtor in property
- transfer to or for the benefit of a creditor
- transfer for or on account of an antecedent debt
- transfer made while the debtor is insolvent
- time of the transfer was within 90 days before the filing of the petition (or 1 year if to an insider)
- transfer enables the creditor to receive more than it would in a Chapter 7 Liquidation and had the transfer not been made
Minimizing Bankruptcy and Foreclosure Risks
Preferences - New Value

Defending a Preference Action

• “New Value” Defenses to a Preference Action
  • contemporaneous exchange for new value
  • subsequent new value

• New Value in connection with a forbearance agreement
  • courts generally reluctant to hold a forbearance of time to be quantifiable value
    • but not all …
      • In re Omniplex Commc’ns Group, L.L.C., 297 B.R.573 (Bankr. E.D. Mo. 2003)
        • held that forbearance allowed borrower to operate equipment, providing quantifiable benefits each day of operation
Defending a Preference Action
(cont’d)

- **Payments Made in the Ordinary Course of Business**
  - transfers should not be avoidable as a preference to the extent the transfers:
  - was made in the ordinary course of business of the debtor and the transferee; or
  - was made according to ordinary terms

- the purpose of this defense is to allow the debtor to continue normal financial relations.
Minimizing Bankruptcy and Foreclosure Risks
Lender Liability - Generally

Lender Liability Claims and Forbearance Agreements and Waivers

• a misstep by a lender in negotiating a forbearance agreement can give rise to certain causes of action by the debtor

• Potential Causes of Action
  • breach of contract
  • breach of the implied covenant of good faith and fair dealing
  • breach of fiduciary duty
  • fraud
  • economic duress
  • tortious interference with a contract
  • control
Minimizing Bankruptcy and Foreclosure Risks
Lender Liability - Control

How Much Control Can a Lender Assert Over a Borrower in Connection with a Forbearance Agreement?

- **Substantial Control**
  - if lender involved in *day-to-day operations* or *management* of the borrower’s business
  - if lender has ability to compel the borrower to engage in *unusual transactions*

- **Determined on Case-by-Case Basis**
  - examples of too much control
    - requiring borrower to liquidate retail line
    - requiring borrower to retain liquidation consultant
    - advising borrower daily
      - note: some courts allow advice without additional acts
    - suggesting which employees to terminate
    - determining appropriate inventory levels
Minimizing Bankruptcy and Foreclosure Risks
Lender Liability - Avoiding Lender Liability

Avoiding Lender Liability claims in Granting a Waiver or Forbearance

• avoid “controlling” the borrower
  • expressly negate joint ventures with borrower in documentation
  • unambiguous language that inspections and monitoring are solely for lender’s benefit
• avoid giving advice on business decisions or day-to-day operations of borrower
• avoid influencing appointment of borrower directors and officers, and hiring and termination of borrower employees
• act within scope of loan documents
• reserve rights to avoid course of conduct waivers
• obtain releases from borrower
Minimizing Bankruptcy and Foreclosure Risks
Intercreditor Agreements - Generally

Intercreditor Agreements in connection with a Forbearance Agreement or Waiver

- the intercreditor agreements set forth the rights of lenders vis-à-vis other lenders
- different creditors may have different objectives and goals with respect to dealing with a borrower on a post-default basis

Sample Provisions:
- payment and lien subordination provisions
- delegation of rights with respect to enforcement actions
- standstill periods and blockage period
- second lien lenders’ agreement not to challenge first liens
- first lien lenders’ ability to sell asset sales free and clear of all liens
- first lien lenders’ ability to put a DIP financing in place
Minimizing Bankruptcy and Foreclosure Risks
Intercreditor Agreements – Consent and Interplay of Lenders

Intercreditor Agreements in Connection with a Forbearance Agreement or Waiver (cont’d)

- **Differing Rights**
  - When entering into a forbearance agreement or granting a waiver, lenders must be aware of the rights of other lenders and requirements under their intercreditor agreements
    - necessary consent
      - forbearance may require the consent of other lenders to be effective
    - targeted forbearance
      - determine which lenders need to forbear
    - cross-defaults
      - determine impact of primary default on other lenders
Minimizing Bankruptcy and Foreclosure Risks
Further Information

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