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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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**STRUCTURING A FORBEARANCE AGREEMENT - THE CREDITOR'S
PERSPECTIVE**

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A Theoretical Framework

Often the most effective action a creditor can take to collect a debt is to refrain from initiating a lawsuit. 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 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. This article focuses on the pre-suit analysis that should be followed, and includes a short checklist of topics that should be considered.

The question of whether to file a lawsuit in an effort to collect a debt, when rationally analyzed, involves an economic analysis. As noted by Peter Toll Hoffman in his article "Valuation of Cases for Settlement: Theory and Practice" "a rational party should settle if it can obtain at least what it would achieve by proceeding to trial and verdict, taking into account all of the economic and non-economic costs of both settlement and trial." A creditor should never accept less in settlement, i.e., consensual workout, than what it believes it would receive through litigation, discounting for the expected expenses of proceeding to trial and for any other anticipated economic, psychological and legal costs. Similarly, the debtor should not pay out in settlement any more than what it expects to lose at trial, increased by the expense of trial and any other economic and non-economic costs associated with the same.

While the analysis seems all too obvious, unfortunately, it is one that both lenders and debtors often fail to undertake. The analysis involves multiple steps. First,

the creditor must evaluate the strength of its legal position. Stated another way, 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, but generally are grouped into the following categories: (1) litigation expenses, (2) the time value of money, and (3) any tax consequences of litigation.

The third step is 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. The assets available to a debtor, whether its own or those of a third party, such as a guarantor serve as a cap on the value of a case. The post-judgment collection efforts will, further, impose additional transaction costs, and could result in the expense, delay and burden of a defensive bankruptcy petition, filed under Chapters 7, 11, 12 or 13 of the Bankruptcy Code.

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. Aside from the repayment terms, the work-out agreement should contain the following defensive provisions:

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. This can be partially achieved through recitals by which the debtor acknowledges the gross loan balance, as well as any material component of the same, including the principal balance, accrued interest, late charges,

attorneys' fees and other miscellaneous expenses. The debtor should also acknowledge the existence of any contractual default. An example of such recitals is as follows:

a. Debtor acknowledges and stipulates that (i) as of the as of [date], Debtor owes Lender the sum of [amount], plus all costs and expenses (including, without limitation reasonable attorney's fees) incurred or paid by Lender in connection with the enforcement of the Note and Mortgage (the "**Stipulated Indebtedness**"); (ii) the Stipulated Indebtedness is comprised of an outstanding principal balance of [amount], accrued interest of [amount], late charges accrued through [date] of [amount], a post-petition advance of [amount], and a Default Prepayment Penalty (as defined in Paragraph 7g. of the Promissory Note dated [date] of [amount], less an escrow balance of [amount]; and (iii) the Stipulated Indebtedness is accruing interest at the per diem rate of [amount], comprised of a pay rate per diem of [amount] and an additional default rate per diem of [amount].

b. Debtor acknowledges and stipulates that it has been, and continues to be, in default under the Note and Mortgage since [date], due to Debtor's failure to make monthly installment payments due under said Note and Mortgage.

2. *Borrower waives or releases claims against Lender.* The workout or forbearance agreement should contain a provision by which the debtor waives or releases any and all claims he/she may have against the Lender. This is true, whether or not such claims have been raised or otherwise articulated to the Lender. If the workout subsequently fails, the creditor wants to preclude the debtor from following the old theorem that a good offense is a good defense. An example of such a provision is as follows:

Waiver of Defenses. The Borrower and the Guarantor (collectively, the "Releasers") have no defenses, setoffs, claims, counterclaims or causes of action of any kind or nature whatsoever with respect to the Loan Documents or the Indebtedness, or with

respect to any other documents or instruments now or heretofore evidencing, securing or in any way relating to any of the Indebtedness, or with respect to the administration and funding of any of the Indebtedness. The Releasors hereby fully and forever release and discharge the Bank and its predecessors, successors, assigns, stockholders, affiliates, directors, officers, employees, agents, attorneys, Independent contractors and representatives (whether now or heretofore acting in such capacity or otherwise) (the "Releasees"), from any and all claims, demands, liabilities, obligations, actions, causes of action or suits at law or in equity, of whatsoever kind or nature, whether known or unknown, discovered or undiscovered, matured or not matured, asserted or unasserted, which the Releasors heretofore had asserted or now or hereafter have or may assert against any one or more of the Releasees, arising out of or in respect of any actions, conduct, circumstances or events on or prior to the date hereof in connection with the administration by the Bank of its financing arrangements with the Releasors. In furtherance and not in limitation of the provisions of the preceding sentence, the Releasor also agrees not to sue or prosecute any action against any or all of the Releasees with respect to any of the matters contemplated within the scope of said sentence, and the Releasors agree to hold each and all of the Releasees harmless in respect of any suit or prosecution by the Releasors in contravention of the provisions of this sentence.

Another example of a waiver/release provision is the following:

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 or counterclaim to the extent any such defense, offset or counterclaim may exist.

3. *Lender's Reservation of Rights:* The lender will probably want to reserve its rights against responsible third parties, such as co-makers, endorsers, or guarantors.

To achieve that, it is often helpful to make that intent explicit in the workout agreement.

An example of such a provision is as follows:

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:* Further, to the extent it remains effective, the borrower should ratify the original loan and security agreement. In this regard, it is often a wise precaution to obtain the guarantor's consent to the work-out agreement. Examples of such provisions are as follows:

Except as expressly amended hereby, the Loan Agreements shall remain in full force and effect. The Loan Agreements, as amended hereby, and all rights and powers created thereby and thereunder are in all respects ratified and affirmed. From and after the date hereof, the Loan Agreements shall be deemed to be amended and modified, as herein provided, but, except as so amended and modified, the Loan Agreements shall continue in full force and effect and the Loan Agreements and this Agreement shall be read, taken and construed as one and the same instrument. On and after the date hereof, the term "Agreement:" as used in the Loan Agreements and all other references in the Loan Agreements, the other documents executed in connection therewith and/or herewith or any other instrument, document or writing executed by Borrowers or furnished to Lender by any one or more of the Borrowers shall mean the Loan Agreements as hereby amended.

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. An example of such a provision is as follows:

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 the automatic stay be waived by a borrower in a carefully prepared pre-petition agreement? The courts have not reached a consensus on this issue. In *Matter of Pease*, 195 B.R. 431 (Bankr.D.Neb.1996) the court concluded that pre-bankruptcy waivers of the automatic stay of §362 are unenforceable. The court reached this decision stating that such waivers are (i) invalid due to the debtor's lack of capacity to act on behalf of the debtor-in-possession; (ii) 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 (iii) extinguished by the Bankruptcy Code which abrogates the freedom to contract around its essential provisions.

Other courts have followed the rationale of *Pease* and refused to enforce pre-petition waivers of the automatic stay. *In re Jenkins Court Assocs.*, 181 B.R. 33 (Bankr.E.D.Pa.1995) (Declining to enforce a pre-petition agreement waiving automatic stay without full development of the facts); *In re Madison*, 184 B.R. 686 (Bankr.E.D.Pa.1995) (Debtor's agreement to temporarily forego bankruptcy protection violates public policy and is unenforceable); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr.W.D.Pa.1989) (Pre-petition agreements waiving the protection of the automatic stay are not self-executing and are not binding per se on the debtor); *Farm Credit, A.C.A. v. Polk*, 160 B.R. 870 (M.D.Fla.1993) (same).

However, the apparent trend in decisional law, particularly in the context of single asset cases, is to enforce contractual waivers of the automatic stay. See *In re Atrium High Point Ltd. Ptrnshp.*, 189 B.R. 599 (Bankr.M.D.N.C.1995) (Pre-petition waivers by debtor of automatic stay are enforceable in appropriate cases where enforcement does not violate public policy concerns, but are not binding on third party creditors); *In re Cheeks*, 167 B.R. 817 (Bankr.D.S.C.1994) (Pre-petition agreements are enforceable on policy grounds encouraging out of court restructuring and settlements, but waivers are not self-executing and are not binding on third parties); *In re Powers*, 170 B.R. 480 (Bankr.D.Mass.1994) (same); *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr.N.D.Ga.1991) (Pre-petition agreement granting creditor relief from the automatic stay was binding on the parties where bankruptcy was filed in bad faith); *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr.M.D.Fla.1988) (same); *In re Gulf Beach Dev. Corp.*, 48 B.R. 40 (Bankr.M.D.Fla.1985) (Holding that while debtor cannot be contractually precluded from filing bankruptcy, the stay would be lifted for cause).

In *In re South East Financial Associates, Inc.*, 212 B.R. 1003 (Bankr.M.D.Fla.1997), the court held that pre-petition waivers are not invalid per se. 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. *In re Orange Park South Partnership*, 79 B.R. 79 (Bankr.M.D.Fla.1987) citing *Duncan Properties, Inc. v. Key Largo Oceanview, Inc.*, 360 So.2d 471 (Fla.3d DCA 1978). Nonetheless, the court found that such waivers are not self-executing and are not binding on third parties. Thus, if a waiver adversely effects other creditors, it is unlikely that the waiver will be enforced. Therefore, in *South East Financial*, although the debtor voluntarily executed a stipulation waiving the right to benefit from the automatic stay, the court determined that it would be inappropriate to enforce the pre-petition waiver. The debtor had eleven scheduled general unsecured creditors. These were third parties who were not bound by the stipulation and who would be detrimentally impacted by dismissal or modification of the automatic stay.¹

¹ In *In re Shady Grove Tech Centers Assocs.*, 216 B.R. 386 (Bankr.D.Md.1998), a detailed restructuring agreement was entered into between the debtor and Massachusetts Mutual Life Insurance Company. The agreement contained a 3-tiered waiver of the right to seek relief under the Bankruptcy Code. At the first tier, the agreement provided, in essence, that the debtor could not to file a petition for bankruptcy before November 1, 1998. At the second tier, the agreement provided that if the debtor should become a debtor in bankruptcy, notwithstanding the first tier promise, that the stay imposed by 11 U.S.C. Section 362(a) would be waived as to actions by the lender against its collateral. Finally, the agreement provided that if the stay did apply as against the lender, the debtor waived the right to defend against a motion for relief from the stay. Citing to the unpublished decision of *In re Merridale Gardens Limited Partnership*, No. 95-1-3091-PM, (Bankr. D. MD. October 19, 1995) the court stated:

No waiver provision will operate automatically, however, resolution will generally be fact sensitive The trend among the courts which have addressed the issue appears to favor granting relief from the stay when the debtor has agreed pre-petition to such waiver. Even if the court chooses not to enforce the agreement, it may weaken the debtor's position and cause the court to look more favorably upon the motion.

Stated another way, a pre-petition agreement that consents to relief from stay, or provides that the debtor will not contest a motion for relief from stay, may be considered a circumstance in determining whether cause exists for relief from stay. Quoting again from the *Merridale Gardens*, the Court noted as follows:

In Illinois, it is unclear whether §362 waivers are enforceable. Therefore, it might be productive to include such waivers in your workout agreement. An example of such a waiver is as follows:

Borrower hereby further agrees that, in consideration of the recitals and mutual covenants contained in this Agreement, in the event that Borrower shall (i) file for or be the subject of any petition under Title 11 of the U.S. Code as amended; (ii) be the subject of an order for relief issued under such Title 11 of the U.S. Code as amended; (iii) file or be the subject of any petition seeking any reorganization, composition, readjustment, liquidation, or similar relief under any present or future federal or state law or act relating to bankruptcy, insolvency or other relief for debtors; or (iv) be the subject of any order, judgment, or decree entered by any court of competent jurisdiction approving a petition filed against such party for reorganization, composition, readjustment, liquidation, dissolution or similar relief, Lender shall thereupon be entitled to relief from any automatic stay imposed by Section 362 of Title 11 of the U.S. Code as amended, or otherwise, on or against the exercise of the rights and remedies otherwise available to Lender as provided in the Loan Documents, the Agreement, and/or as otherwise provided by law. Borrower further waives any right it may have to move in such proceeding to extend the exclusive period to file a plan or have a plan accepted, unless Lender has been granted relief from the stay.

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I believe that in the final analysis waiver is a factor in the decision as to whether cause exists to modify the stay, and as in so many bankruptcy cases it is a balancing process that requires consideration of a number of factors. I have set forth some of those factors. One, the sophistication of the party making the waiver; two, the proximity in time between the waiver and the filing of the bankruptcy case; three, the consideration for the waiver; that is are there substantial concessions, is the risk assumed by the lender, that is if the lender is undersecured does the lender go further out, is the debtor under water, what is the length of the forbearance. Another factor I would consider is the feasibility of the debtor's plan going back to the water front, is the plan one of a rising tide raising all boats; is it a Cinderella plan that "some day my prince will come;" is it a plan that depends upon either lightning or flood to convert an inventory into cash, or is there positive cash flow. Finally, the last factor is whether other parties are affected, is there a large unsecured group of creditors, are there junior liens that will be wiped out, are there subordinated leases that will disappear are there employees who will have a job if the stay is terminated?"

