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### **Commercial Workout and Forbearance Agreements**

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#### **I. Introduction**

#### **II. Limitations of Presentation: Commercial law only. No consumer law.**

#### **III. Life in a Recession.**

- a. From 2002 to 2008, distressed businesses (and their lenders) often had multiple options:
  - i. Increase sales. Demand for the product existed, just gain more market share.
  - ii. Cut costs. Sufficient sales existed to make a profit at some price.
  - iii. Refinance. Especially attractive because of increasing collateral values.
  - iv. Sell the business (or a part). Greater fool theory—private equity, hedge funds.
  - v. Sell the loan.
- b. Now:
  - i. Demand for some goods and services has contracted so much that no work-out is possible. E.g., housing and construction. Impossible to cut costs enough to survive with no sales.
  - ii. The greater fools are gone. Credit has dried and equity is bottom fishing.
  - iii. Still, a forbearance period can add value by allowing Bank and Borrower to expose the assets and the business to the market.

#### **IV. Commercial Loan is in Default. Initial Steps.**

- a. Give written notice of default and demand for payment. This will start cure clock.
- b. Demand payment of all amounts currently due (i.e., arrearages).
- c. Trigger default rate of interest, and other charges.
- d. Reserve all rights and remedies.

- e. Avoid making any promises. “The loan documents are in full force and effect unless we enter into a written, signed modification. Do not assume the Bank will do a workout.”
  - f. Thorough review of loan and security documents to determine if any defects or deficiencies exist.
- V. **Enforce or Work Out? Or, Start Enforcement, then Work-Out? Factors to Consider:**
- a. Often best to start enforcement, then move to forbearance/workout.
    - i. 6-9 months to complete a foreclosure action in Maine.
  - b. Value of Collateral. Going Concern vs. Orderly Liquidation vs. Forced Liquidation. Are continued operations critical to preservation of value?
  - c. Is collateral safe?
    - i. Insured?
    - ii. Mechanic’s Liens?
    - iii. Unpaid Real Estate Taxes?
    - iv. Unpaid Personal Property taxes?
    - v. Sewer or Water Liens?
    - vi. Attachments by other creditors? Subsequent advances by Bank after statutory notice from attaching creditor can be subordinate. (Section 505 notice for real estate and Article 9 for personal property).
  - d. Time to liquidate in enforcement action.
  - e. Cost of enforcement.
  - f. Will Borrower cooperate in work out, and will it matter? Can the Borrower add meaningful value in workout?
  - g. What caused the financial difficulty and default?
    - i. Competition.
    - ii. Declining economy.
    - iii. Declining sector.
    - iv. Management inattention or lack of drive.
    - v. Loss of key customer(s).
    - vi. Loss of key employee(s).
    - vii. Excess leverage.
    - viii. One-time event, such as lawsuit or governmental enforcement action.
  - h. Unpaid income or withholding taxes? These have high penalties and interest, and are difficult to deal with. Bad sign.

- i. What is Borrower's proposed solution? (Bank should listen, not propose a business solution.).
  - i. Debt Restructure.
  - ii. Operational Restructure.
  - iii. Refinance.
  - iv. Sale of whole or part.
  - v. Increase sales.
  - vi. Cut costs.
- j. Sale of loan?
- k. Is the Borrower providing information as required and requested by Bank?
- l. Any irregular activity in Borrower's accounts?
  - i. Payments to insiders?
- m. Rights of set-off?
- n. How long has the Bank done business with the Borrower, and has the relationship been good?
- o. Are jobs at stake? How important is this business to the community?
- p. Do government guarantees (e.g., SBA, FAME) exist? Does workout require consent of guarantor?
- q. Are government (e.g., SBA, FAME) guarantees available?
- r. Are government concessions (e.g., Pine Tree Zone, TIF District) available?
- s. Is the Borrower communicating with the Bank?
- t. What corrective steps has the Borrower taken?
- u. Does the Bank believe the Borrower can work out of the problem?
- v. Does the Bank TRUST the Borrower? Essential.

**VI. Pre-Negotiation Agreement: Protection Against Lender Liability**

- a. Overview
  - i. Do it Early
  - ii. Shields against misunderstandings--"The Banker led me along and implied that he would work with me. He said 'I'm sure we can work this out.'"

- b. Specific Provisions
  - i. Discussions are occurring at the request of the Borrower
  - ii. Bank has no duty to negotiate
  - iii. Loan Documents are still in force
  - iv. Bank has not waived any rights; reserves all rights
  - v. No oral modifications; any change must be in writing and signed by all parties.
  - vi. Discussions are for settlement; not admissible in evidence.
  - vii. Any party may terminate discussions at any time, for any reason.
  - viii. Consider asking for stipulation regarding loan documents. Depends on the circumstances. Overreaching could spoil the relationship.
  - ix. Borrower make seek a standstill. Whether to give it depends on the circumstances.

**VII. Protocol For Bank Conduct in Negotiations**

- a. Assume *everything* you *say* will be repeated to a judge or jury in a lawsuit against the Bank.
- b. Assume *everything* you *write* will be repeated to a judge or jury in a lawsuit against the Bank. This includes internal memoranda, such as e-mail.
- c. BEWARE of E-MAIL!! Do not send unnecessary internal or external e-mails. Avoid anything extraneous. Keep them factual and boring.
- d. The Bank's internal memoranda is discoverable, and will be given great weight in a lawsuit against the Bank. They reveal what the Bank was "really thinking."
- e. Communications with Counsel are generally protected by the attorney-client privilege.
- f. Be professional and civilized. Do not make it personal.
- g. Be direct. Stick to legal rights under the documents.
- h. The Bank's only motivation is to be repaid.
- i. Do not reveal any other factors that may influence the Bank's decisions. (E.g., do not say "my boss just wants this loan off the books by the end of the quarter").
- j. Be reasonable in demands.
- k. Ultimate goal is to have everyone who looks at the transaction conclude that the Bank acted "reasonably."

## **VIII. Bank Due Diligence**

- a. Request Information (usually permitted under the loan documents).
  - i. List of collateral
  - ii. Location of collateral
  - iii. Appraisals
  - iv. Financial statements--income statement, balance sheet and cash flow projections, including cash burn analysis. Bank and Borrower need to know when Borrower will be out of cash.
  - v. Financial statements of guarantors. Consider financial affidavits.
  - vi. Turnaround plan, with specific action steps. Proforma financial statements.
  - vii. Refinance prospects.
  - viii. Sale prospects
- b. UCC-11 search (personal property)
- c. Title Search (real estate)
- d. Appraisals of collateral.
  - i. Having Bank's attorney order it may protect the privilege. Usually best to avoid sharing with Borrower.
- e. Borrower's turnaround consultant. Usually desirable to have the Borrower hire the turnaround consultant because Borrower will want to have the benefit of the work. Bank may wish to furnish names of acceptable candidates. Sometimes, funds are not available. Will Bank advance for this?
- f. Bank's turnaround consultant.
  - i. Having Bank's attorney retain the consultant may protect the privilege. Usually best to avoid sharing results with Borrower.
- g. Workout officer must understand the Borrower's business.

## **IX. Forbearance/Workout Agreement--Elements**

- a. Factual Recitals and Stipulations.
  - i. Loan Documents.
  - ii. Amounts currently owed to Bank. Debt is valid and enforceable.
  - iii. Outstanding balances.
  - iv. Reaffirmation of Bank's senior position in all collateral (with any exceptions expressly noted).
  - v. Defaults (admitted by Borrower).
  - vi. Waiver by Borrower of defenses to repayment, including waiver of rights of setoff.
  - vii. Borrower releases Bank from all claims.
  - viii. Demands made by Bank are valid and enforceable.
  - ix. Specific rights and remedies held by Bank.

- x. Borrower has no equity in collateral (this will help Bank obtain relief from stay in a bankruptcy case).
  - xi. Borrower cannot adequately protect Bank's interests (same).
  - xii. Schedule of Borrower's trade payables and other liabilities, noting any that are disputed. (could help with later involuntary bankruptcy).
  - xiii. Forbearance agreement is commercially reasonable.
- b. Statement of Consideration to be received by Borrower in exchange for forbearance and other concessions by Bank.
- c. Representations and Warranties
- i. All factual recitals and stipulations are true and accurate. Failure of any would constitute an event of default.
- d. Terms of Workout/forbearance--What the Bank Gives Up. Examples.
- i. Bank agrees to forbear from enforcing rights under loan documents until an agreed upon "expiration date." Bank's obligation to forbear is subject to Borrower not committing any event of default under the workout agreement.
  - ii. Maturity date of the loan is extended to the expiration date.
  - iii. Bank may agree to waive certain covenant defaults (e.g., cash flow coverage ratio) during the forbearance period.
  - iv. Bank may agree to continue revolving line of credit and/or lend new money. Best to include general description of new loans or amended terms in workout document, and draft new loan documents or amendments to existing loan documents.  
    - NOTE:** if Bank will advance new funds, consider making new funds subject to entry of a Bankruptcy Court Order with full spectrum of protections. This would require the Borrower to file for bankruptcy.
  - v. Bank may agree to a partial release of collateral in exchange for a specified payment. This gives Borrower certainty and is helpful in selling real estate subdivision parcels and condominium units.
  - vi. Bank may agree to waive notice of default, demand for payment and acceleration of loan.
  - vii. Rarely would it be prudent for Bank to agree in advance to reduce its claim. Bank should reserve right to consider any refinance or sale offer, and to release collateral for a "short sale." Bank should retain its deficiency claim to pursue later against the Borrower and guarantors, and to assert defensively, if necessary, against claims brought by Borrower, Creditor's Committee or Trustee.
  - viii. Consider giving guarantors incentive to maximize recovery, such as through deficiency limitation agreement.
- e. Terms of Workout/forbearance--What the Bank Receives. Examples.
- i. Correction of any problems with the loan and collateral documents.
  - ii. Entire loan matures at end of forbearance period. Additional time for Debtor to refinance or sell results in better recovery. This gives the Borrower time to refinance or sell.

- iii. Borrower grants Bank a full release and (if possible) indemnification for losses relating to the workout agreement. Consider a stand-alone release and indemnity document that would survive even if it is later alleged that that Bank breached the workout agreement.
- iv. Cooperation of guarantors, especially if limitation of deficiency liability is a possibility.
- v. Agreement by Borrower that Bank's acceptance of partial payment after foreclosure action is filed shall not constitute a waiver of the foreclosure. Absent this agreement, any acceptance of payment by the Bank waives the foreclosure. See 14 M.R.S.A. §6204.
- vi. Consented to relief from automatic stay in future bankruptcy filing. (These provisions are not always enforceable. The outcome may depend on the extent of the Bank's concessions in the workout agreement).
- vii. Borrower grants liens and confirms Bank's right of setoff in deposit accounts.
- viii. Additional collateral.
- ix. Additional guarantees.
- x. Security for existing guarantees.
- xi. Borrower to obtain additional capital investments--new equity.
- xii. Borrower to employ consultants and/or Chief Restructuring Officer.
- xiii. Borrower to retain investment banker to sell business.
- xiv. Borrower waives notice requirements.
- xv. Borrower to report financial performance and sale/refinance prospects.
- xvi. Borrower to achieve certain benchmarks or milestones.
- xvii. Waiver of jury trial.
- xxviii. Deed in lieu of foreclosure (held in escrow). (Not effective if junior liens need to be scraped).
- xix. Consent to foreclosure judgment (held in escrow). (Difficult unless foreclosure complaint was already filed).
- xx. Agreement of possession (held in escrow).
- xxi. Power of attorney for Bank to execute certain documents on behalf of Borrower to effectuate the terms of the deal.
- xxii. Forbearance fees.
- xxiii. Creation of favorable impression--"Bank acted reasonably"--in future enforcement action that may be contested by Borrower, or by Creditor's Committee or Trustee in Bankruptcy.
- xxiv. The forgoing list does not exhaust all of the possibilities.

## **X. Closing Thoughts.**

- a. Workouts cannot be reduced to a formula. Every situation is different. Successful workout officers have good judgment--"Know when to hold 'em, know when to fold 'em, know when to walk away, know when to run." (Kenny Rogers).

- b. It is far more difficult to achieve a good liquidation event now than it has been. Workouts were not necessary when Borrowers and lenders had so many options:
  - i. New equity
  - ii. Refinance
  - iii. Sale of business (whole or part)
  - iv. Sell loan
  - v. Grow the top line
  - vi. Cut costs
  
- c. Bankruptcy can be good for the Bank, and is rarely bad. If the bank has already given the Borrower a chance in the form of forbearance, then bankruptcy is likely to be better.
  - i. In distress situations, a sale or refinance outside of bankruptcy is usually impossible.
  - ii. A bankruptcy sale allows a buyer to acquire the assets and leave behind the liabilities.
  - iii. Bankruptcy court order shields the buyer, leading to a higher purchase price.
  - iv. All bankruptcy sales allow competitive bidding. Outside of bankruptcy, a buyer will want to lock up the process through a “no shop” and eliminate competition.
  - v. Stalking horse bidders get protection.
  - vi. Automatic stay allows the Debtor to focus on the sale process.
  - vii. Section 363 process is a well-worn path. Predictable and fair process.
  - viii. In order to achieve going concern value, Bank does not need to take possession.
  - ix. Court and creditor oversight; federal criminal laws regarding disclosure.
  - x. Court orders approving new lending--debtor-in possession (“DIP”) financing.
  
- d. Forbearance Agreements can greatly improve the Bank’s position.
  - i. Bank is released of all claims (through the date of signing).
  - ii. Bank’s claim is liquidated.
  - iii. Path to enforcement is shortened.
  - iv. Position in Bankruptcy is enhanced.
  
- e. Avoid Lender Liability
  - i. Do not tell the Borrower which claims to pay and not pay.
  - ii. Do not “control” the Borrower.
  - iii. Stick to the rights and remedies in the loan documents.