THE COMMERCIAL REAL ESTATE LOAN WORKOUT: STRATEGIES FOR MINIMIZING LOSSES IN A TROUBLED MARKET

By

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The housing market has finally begun to show signs of recovery,[2] signaling the beginning of the end of unprecedented levels of home mortgage foreclosures in most markets.[3] The forecast for commercial real estate markets is not nearly as sanguine. Tight credit markets, continued high unemployment and the poor economy have left commercial property owners unable to meet or refinance mortgage debt obligations, contributing to soaring commercial real estate loan defaults. The situation is likely to worsen as loans come due, credit remains scarce[4], and property values continue to deteriorate.

In this market, and considering the time and costs involved in obtaining a foreclosure judgment and then holding and remarketing foreclosed property, simply foreclosing and taking back the property may result in losses to the lender. If the borrower files for bankruptcy, additional issues will also arise with the potential to detrimentally affect the lender's position.

A successfully negotiated structured loan modification, or "workout," often provides a better alternative to maximize the lender's recovery on a commercial loan, especially in the current environment. A "workout" has been aptly described as "a dynamic process that in the first instance identifies problems in and then redefines the relationship between a lender and a borrower. It is an art, not a science. A successful workout requires a combination of business, legal, and psychological acumen."[5] Seeking to provide at least the business and legal acumen that a successful workout requires, this article will discuss the considerations involved in and process of negotiating a successful loan workout, primarily from the standpoint of a lender's workout counsel.

<u>I. Before the Restructuring: Early Warning Signs and Considerations for the Lender</u>

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[2] The 2Q 2009 S&P/Case-Shiller Home Price Index ("S&P/SCI") reflected the first uptick in housing prices since 2007.

[3] Notable exceptions include certain markets in California, Nevada, Arizona and Florida, which reported 23% home mortgage loans in default as of September. The S&P/SCI excludes condominium prices, which are also under increased pressure in Florida.

[4] The $700 billion commercial mortgage-backed securities (CMBS) market lacks new money for buyers or refinancing. "*Commercial Real Estate: From Bad To Worse,*" Maurna Desmond. Forbes, July 14, 2009.

[5] "From Borrower to Debtor: Warning Signs and Protective Procedures to Protect Your Investment," Scott Lessne, and Thomas Cambern. CLE Materials for "Anatomy of a Loan Workout." See Footnote 1.

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Lenders should be proactive and diligent in watching for warning signs of loan deterioration, before a payment default appears. The lender who notices the signs early, evaluates their causes expeditiously, and takes prompt action in response, will invariably have the better outcome.

Early signs of potential problems may be external to the situation of a particular borrower, or they may be specific to a loan. External signs of potential losses include factors present in the current environment, i.e., a weak market, poor economy, scarcity of new credit, as well as weakness in the specific borrower's industry.

Loan-specific warning signs may include rising balances in the borrower's revolving credit facilities, use of revolving credit to pay down term loans, increasing requests for covenant relief, sudden changes in the borrower's ownership or management (in particular, positions of financial responsibility), unexplained reductions in EBIDTA, or failure of the borrower to provide financial statements, collateral reports, or other required information. Any of these events should trigger prompt investigation and analysis by the lender to determine the cause, and to assess whether the situation may worsen and/or lead to payment default.

Unless the lender feels assured after its own investigation that the credit will continue to perform according to its terms, it should begin preparing for the possibility of a workout or enforcement proceedings. This is also the time for the lender to engage outside workout counsel who is knowledgeable about enforcement remedies in the jurisdiction to assist in the process. Although the best financial outcome may be achieved through a negotiated workout, rather than enforcement and foreclosure, knowledge of enforcement remedies (and using that knowledge effectively in the negotiations) as well as bankruptcy law, is essential to achieving the best result.

Outside counsel can also serve as a useful buffer between lender and borrower. As a loan deteriorates and the borrower's desperation increases, the borrower may increasingly seek concessions, waivers, and modifications from the lender. The borrower may then try to use (and distort) the content of its direct communications regarding covenant relief, default, enforcement, and potential modification against the lender. For example, a borrower might claim that the lender agreed to a covenant waiver or some other type of forbearance. If the borrower's communications are instead channeled through outside counsel, the borrower ability to use them to its advantage against the lender will be greatly reduced

After engaging outside counsel to assist in the workout, the lender should also convey to counsel institutional objectives which may not be readily apparent, including potential regulatory and/or accounting concerns that may affect the lender's decision-making (in addition to providing information specific to the loan), so that outside counsel can gain a complete understanding of the lender's goals and interests.

II. Due Diligence: Critical Information about the Loan and the Borrower

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To structure a successful modification, it is essential that the lender and workout counsel have information necessary to perform a thorough due diligence analysis. The following information and documents should be fully reviewed and understood:

- the nature of the borrower, its business and apparent causes of present financial distress;
- all loan documents including all notes, amendments, and security agreements;
- all written correspondence (including emails) with the borrower;
- UCC-1's, rent assignments, and other documents describing collateral;
- account notes/loan or account history reflecting current balance and interest charges;
- the existence and the status of the borrower's other major creditors and/or lienholders;
- all specific event(s) and date(s) of all uncured defaults;
- the status of communications with the borrower regarding the current default(s);
- the lender's course of dealings with the borrower on past defaults, and whether there has been a history of waivers of defaults or course of dealing contrary to the loan terms;
- the nature, location, and value of all collateral and whether security interests are perfected;
- the identity of the borrower's other primary secured creditors and the collateral securing that debt.

Particular attention should be paid to loan document terms identifying defaults and remedies on default, default interest rates, cure periods, and the borrower's covenants other than payment of the debt, including terms requiring the debtor to provide financial information and reports, permit inspection of collateral, and authorizing the lender to obtain appointment of a receiver. This information will be useful in the workout process or litigation, should litigation be required.

Internet searches should also be conducted on the borrower, using Google or other search engines, and its corporate status should be confirmed with the Secretary of State. Searches can also be conducted for other litigation against the borrower using Westlaw or Lexis service.

A. Interviewing the Loan Officer. After reviewing the documents and information gathered from public sources, workout counsel (and in-house counsel, if available) should interview the loan officer to gather information which might not be reflected in the documents, but will be important in evaluating the borrower and its potential defenses, including:

- What communications have occurred with the borrower as to current defaults (including telephone conversations) and how has the borrower responded?
- What has the borrower told the lender about the causes of its financial problems and how it expects to repay?

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- Are other lenders or creditors are causing issues for the borrower?
- Has the loan officer visited the borrower's business, and if so, what did he/she observe?
- What discussions and communications has the officer had with the borrower with respect to prior defaults?
- Has the borrower threatened lender liability claims?

B. <u>Analysis of Collateral.</u> By its nature, a workout contemplates a delay in enforcement of certain remedies. This delay could result in loss or dissipation of collateral.

Therefore, early in the workout process the lender and its counsel should work together to determine the nature and value of all collateral securing the loan, the risk of loss associated with the collateral. Together, they should develop a plan to preserve and prevent further losses of collateral during the workout process and protect or enhance the lender's collateral position. Workout counsel will want to:

A. Identify all collateral described in the security agreements, mortgages, UCC-1's, assignments of rent, receivables or other assets and confirm that all security interests granted in loan documents are properly perfected.

B. Determine whether there are other creditors who may have competing interests:

1. Has the debtor identified other creditors in its financial statements and/or business plan provided to the lender?
2. Conduct a UCC-1 search to determine other UCC-1's filed against the collateral.
3. If the borrower does not own real property at which collateral may be located, determine the existence, extent and priority of any landlord's liens on that collateral.
4. Determine whether the lender has received any purchase money security interest (PMSI) notices from finance companies supplying goods or equipment.
5. Run a property search to determine whether there are other mortgages on the same property.

C. Determine the value of all collateral:

1. Review existing appraisals.

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2. Obtain updated appraisals from an appraiser qualified to testify as an expert in the event of bankruptcy.
3. Obtain and analyze rent rolls.
4. Conduct on-site audits of inventory and any other collateral at the borrower's locations.
5. Demand the borrower to provide all financial reports called for in the documents.
6. Evaluate the risk of dissipation and loss of collateral and assist the lender in developing a plan for monitoring it closely.
7. Determine whether the borrower has funds on deposit available for set-off and evaluate the risk to the borrower's business resulting from set-off.

D. Develop a plan to protect existing collateral.

To the extent permitted by the loan documents, a procedure should be put in place for continuous monitoring of the collateral to ensure it is not used outside the ordinary course of business.

III. Evaluating Collateral Remedies

Only when the facts relating to the loan, the borrower, and the nature, value, and status of the collateral are fully understood, can a determination be made as to whether and the extent to which a workout modification, as opposed to immediate enforcement, is in the lender's best interest, and an effective workout strategy planned. For example, the lender and its workout counsel should consider:

A. The likelihood the borrower can survive and whether the borrower is taking concrete steps to survive, as opposed to merely biding time (and dissipating cash and other assets) until the inevitable occurs.

B. To what extent collateral can be retaken without legal action, for example, by surrender (in the case of personal property), or set-off in the case of deposit accounts.

C. The risk of loss of the collateral if enforcement action is not taken, including ongoing loss or diminution of collateral value resulting from:

- Use/dissipation of rents, profits, deposit accounts, proceeds, receivables and other cash collateral.
- Sale of inventory in the ordinary course of business.
- Sale or disposal of assets outside the ordinary course of business.

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D. Whether the liquidation value of the collateral is sufficient to make the lender whole if enforcement remedies are exercised, and if not, the extent of other repayment sources. If enforcement will not make the lender whole, what collateral does the borrower need to stay in business to generate income for repayment? If so, how can dissipation of existing collateral needed for the debtor to stay in business be prevented?

E. The lender's capacity to manage the real estate, and to repossess and liquidate the collateral in a commercially reasonable manner.

F. Location of the collateral and possible need for filing suits in multiple jurisdictions to recover it.

G. What other collateral or agreements might the borrower offer in exchange for forbearance?

H. If enforcement remedies are exercised, the risk the borrower will raise defenses or assert lender liability counterclaims. For example, is the borrower likely to argue that a past course of dealings or communications with the lender resulted in waivers of terms or agreements to modify? Or, that the lender did not comply with the terms of the loan, letters of assurance or other representations made in communications? Are there grounds for the borrower to assert that the lender exercised undue control which might result in lender liability counterclaims?

I. The risk of a bankruptcy filing, how it will affect the lender's position, and what steps can be taken in a workout to improve the lender's position if/when bankruptcy is filed.

IV. Litigation and Mechanics for Enforcing Lender's Collateral Remedies

A workout should always be structured in contemplation of the possibility of future enforcement litigation and/or bankruptcy of the borrower, with the dual goal of (a) strengthening the lender's position legally and in collateral in the event legal action is required, and (b) minimizing borrower defenses.

Even when a negotiated workout is the goal, enforcement litigation may be useful to halt collateral dissipation, or eliminate sub-liens. For example, even when the lender and borrower reach an agreement with respect to the borrower's obligations, a "friendly foreclosure" may be used by the lender solely to eliminate sub-liens. Where elimination of sub-liens is not an issue, commencement of enforcement litigation may still provide, in addition to tools for collateral preservation, a framework for a workout agreement which may be blessed by the court and limit future litigation in the event of further default.

All liens on collateral covered by the Uniform Commercial Code ("UCC") (for example, liens on intangibles, accounts, proceeds, and personal property) must be enforced in compliance with Article 9 of the UCC in order to protect the lender from possible claims associated with its

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recovery and disposition.[6] Methods for lien enforcement against collateral will vary logistically depending on the status and location of collateral.

A. Enforcing Interests in Tangible Personal Property. If a borrower refuses to assemble or voluntarily surrender collateral as may be called for in the loan agreement, the UCC permits a lender to use self-help to repossess personal property collateral such as goods, equipment and inventory (including raw materials) to the extent it can do so "without breach of the peace[7]."

However, the lender will often need court assistance to recover collateral. State laws vary as to their procedures for court sanctioned repossession of collateral prejudgment and requirements as to court hearings before issuance of a replevin or recovery order. In many cases, an order for recovery of personal property collateral may be obtained without notice or hearing, but only after the posting of a bond. Other procedures contemplate obtaining a hearing, with fairly short notice.[8]

Recovering collateral will stop its loss, put the lender in control, and get the borrower's attention, which may give the lender an advantage in workout negotiations. On the other hand, a lender in possession of collateral must treat the collateral in accordance with the requirements of the UCC or face loss of deficiency rights or possible damage claims. For example, if the lender elects to sell or dispose of the collateral, it must give proper notification before the sale to the borrower, guarantor, and other parties with an interest in it, sell or dispose of it in a commercially reasonable manner, and apply the proceeds as required by the UCC.[9]

If the lender wishes to accept the collateral in full or partial satisfaction of the debt (also known as "strict foreclosure"), the lender must send notification of its proposal to do so to the

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[6] A thorough analysis of Article 9 remedies and requirements is beyond the scope of this article, but can be found in *"UCC Article 9 and the Exercise of Secured Party Remedies,"* by Lynn Soukup, presented June 2, 2009, by the ABA Uniform Commercial Code Committee, Commercial Finance Committee and ABA Center for Continuing Legal Education and is available online at the ABA website.

[7] See: UCC §9-609.

[8] Florida, for example, provides alternative procedures for quick prejudgment recovery of personal property collateral in Chapter 78 Florida Statutes ("Replevin"). Under this statute, property may be seized forthwith under a replevin writ issued ex parte and without notice if the claimant establishes the right to its possession by affidavit (for example, alleging that the items are subject to a security interest and the borrower has failed to pay as agreed), and posts a bond for the lesser of twice the value of the property, or twice the amount of the debt as security if the writ is found to be wrongfully issued. Fla. Stat. §78.068. Alternatively, the claimant can request the Court to issue a show cause order and set a hearing at which the party in possession is required to show why the property should not be taken from it and delivered to the claimant. Fla. Stat. §78.065. The obvious risk of using the second procedure is notice to the borrower in advance resulting in loss of the collateral. Therefore, it is the opinion of the author that it not advisable to proceed with notice unless the right to possession does not stem from a security agreement, or the secured party's right to repossession under the security agreement is in question.

[9] UCC §§ 9-610, 9-615.

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borrower and other parties claiming an interest in the collateral.[10] Strict foreclosure requires the lender to act in good faith, but there is no requirement for it to act in a commercially reasonable manner.

Therefore, before recovering collateral, outside counsel should advise the lender to consider how it will store collateral after it is recovered, how it will dispose of it to comply with UCC requirements of commercial reasonableness and good faith, if a strict foreclosure, and whether and to what extent strict foreclosure may be appropriate.

B. Deposit accounts, proceeds, accounts. Enforcing interests in collateral such as deposit accounts, proceeds, and the accounts of the borrower may be simpler and faster than enforcing interests in personal property collateral.

For example, to the extent the lender has control over a deposit account which is pledged as collateral for the debt, the lender may take and apply the funds in the account to the obligation.[11] Even if a deposit account is not specifically pledged, if the lender has a security interest in proceeds (of other collateral) in a deposit account, this also provides a ground for claiming funds in the account are collateral which the lender may take and apply to the debt.[12] If the borrower's "accounts" are pledged, the lender may also directly enforce the obligations of the borrower's account debtors.

C. Foreclosure of the mortgage on real estate. If there are junior mortgages, liens or other encumbrances, and the junior lienholders are not part of the workout, a foreclosure action will be required to clear title. Filing a foreclosure action may also be an effective means to bring the borrower to the table to negotiate a workout within the action. Mortgages on real property must be foreclosed in accordance with the procedures available under the law of the state where the property is located. In Florida, a lawsuit must be filed seeking foreclosure of the mortgage, the claims are litigated, judgment must be obtained, and the property must be sold thereafter at foreclosure sale for certificate of title to issue to the lender. Claims may be brought in the same litigation on the note, for foreclosure of the security interest, and on guaranties. Florida also provides a streamlined foreclosure procedure whereby the lender may obtain an order to show cause why the foreclosure judgment should not be entered.[13]

D. Assignments of Rent. If rents are assigned as additional collateral under the mortgage or by separate documents, the law of the state where the property is located may provide for specific additional relief for the lender. For example, in Florida law, a rent assignment is perfected upon recording of the mortgage, and is enforceable upon the borrower's default and the lender's demand for payment of the rent.[14] Florida law also provides a procedure for the mortgagee to obtain immediate sequestration of rents, in order to prevent their dissipation

[10] UCC §§9-620; 9-621.
[11] UCC §9-607(1)(d).
[12] UCC §9-607(1)(b).
[13] Fla. Stat. §702.10.
[14] Fla. Stat. §697.07.

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by the borrower.[15] A motion for sequestration of rents should be filed together with the foreclosure complaint. Sequestration under the statute contemplates deposit of the rents in the court registry. But after the motion is filed, counsel can negotiate with the borrower for deposit and use of the rents in a more convenient manner.

E. <u>Appointment of a Receiver.</u> Commercial mortgages typically contain terms under which the lender may obtain a receiver to take control of and manage mortgaged property and rents. During the due diligence process, the lender and workout counsel should have considered the lender's ability to manage the property, and found an entity suitable and acceptable to the lender to do so. In filing a motion for appointment of a receiver, the lender can request appointment of the entity it has preselected for this purpose, rather than ask the Court to appoint a third party.

V. Use of Enforcement Remedies in the Negotiated Workout

As loan performance deteriorates, the goals and interests of the lender and the borrower will increasingly diverge. The lender's primary goal is to restore the loan to performing status, so as to avoid charge-off. But in the current market, the borrower may be unable to find sources for repayment to pay off or perform the loan's terms.

If the borrower cannot perform or payoff the loan, the lender's secondary goal is to maximize recovery and minimize losses. The borrower's goal is to stay alive and in control of its assets and revenue stream, even though its continued use and consumption of assets will lead to greater losses for the lender if the loan cannot be restored to performing status or restructured satisfactorily. The borrower often will not be inclined to voluntarily permit the lender to take control of any collateral asset. The lender will also prefer not to enforce remedies against collateral, if this can be avoided.

Workout counsel must advise the lender on how best to structure a solution to protect the lender given its concerns, and the likely response of the borrower. Often, taking initial legal steps to enforce the lender's interest in the collateral, even if the lender's ultimate goal is not to own it, is the best way to force the unrealistic borrower to agree to a workout solution acceptable to the lender.

Thus, while completing a foreclosure action and taking back real property which the lender will then have to manage and sell is typically not a desired result, the threat to the borrower of imminent loss of access to the cash generated by the property and other assets attendant to the filing of a foreclosure action, a request for rent sequestration and/or a receiver, and/or recovery of personal property collateral, will usually force it to the table and motivate it to agree to workout terms acceptable to the lender which don't include owning the property. By initiating enforcement litigation, the lender may also be able to obtain some immediate payment on the debt from collateral seized through legal action, and/or convince the borrower to provide additional collateral, in exchange for some form of forbearance and abeyance of foreclosure.

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[15] Id.

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Since the lender as plaintiff will be seeking relief in the litigation, a state court will not force the lender to move the case quickly. Rather, the lender can file the enforcement litigation, seek collateral orders, and then use the litigation to bring about a workout agreement. In sum, commencement of enforcement litigation to facilitate a workout may confer the following benefits:

- Rent sequestration orders or other restrictions on rent use;
- Orders to stop collateral losses while workout discussions occur;
- Orders for the appointment of a receiver;
- Time for negotiating how collateral will be handled, including procedures for sale of repossessed collateral;
- Minimizing risks of borrower defenses based on waiver, course of dealing, or modification of terms outside the documents;
- A framework to conduct workout negotiations as settlement communications, which are generally inadmissible under rules of procedure and cannot be used against the lender in the enforcement litigation, unlike discussions outside of litigation;
- A facility for joining junior lienors and negotiating their interests in collateral at the same time, including negotiating agreements as to treatment of claims and liens in the event of bankruptcy;
- Structure for obtaining admissions to the validity of the debt and the lender's security interest, as well as waivers of defenses to future enforcement should the borrower default under the workout;
- Means to obtain faster judicial relief for the lender should the borrower default under the workout, for example, by entry of judgment;
- Court approval of the workout agreement.

VI. Bankruptcy Considerations

The impact of the borrower's bankruptcy must always be carefully analyzed in a workout situation. While many issues may arise in bankruptcy,[16] three primary bankruptcy planning considerations for the lender in a workout are: (1) the impact of the bankruptcy stay; (2) protecting, maintaining and/or improving the lender's secured position in collateral, and (3) mitigating risks of preference and avoidance claims by the debtor or trustee.

A. Automatic Stay. The filing of a bankruptcy case operates a stay (or injunction), prohibiting, inter alia, the following:

> (1) the *commencement or continuation*, including the issuance or employment of process, of *a judicial,* administrative, or other action or *proceeding against the debtor* that was or could have been commenced before the commencement of the case, or to recover a claim against the debtor that arose before the commencement of the case;

[16] An analysis of all bankruptcy issues is beyond the scope of this presentation.

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(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) *any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;*

(4) *any act to create, perfect, or enforce any lien* against property of the estate;

(5) *any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title*;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.[17]

Thus, the automatic stay requires the complete cessation of all efforts to: (1) collect or enforce debts from the debtor, (2) repossess collateral, and (3) perfect or enforce liens against property of the estate, including the recording of a UCC-1 financing statement, lien, or mortgage. Thus, in initial planning states of a workout, the lender and its counsel should ensure its security interests are properly perfected, and that it enforces rights against collateral such as deposit accounts before filing occurs.

B. Maintaining or strengthening the lender's collateral position. The bankruptcy code deals with "creditors" holding "claims." A claim is defined as "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.[18]"

Claims in bankruptcy are paid in accordance with priorities set forth in the bankruptcy code. Generally, all claims in the same class must be treated alike in descending order according to the priority of the class.[19] Thus, creditors holding secured claims are entitled to be paid ahead of unsecured claims, based on the value of the collateral securing their claims. All unsecured claims must be treated alike, and unsecured claims are paid only after secured claims are paid.[20]

Outside of bankruptcy, unperfected security interests are still enforceable against the borrower (subject to any other perfected liens in the same collateral). This is not the case in bankruptcy. Creditors with unperfected security interests are treated as having no security interest, i.e., unsecured claims in bankruptcy proceedings. Since the automatic stay prevents post-petition perfection of security interests, pre-petition perfection is essential, and should be an early step in the workout process.

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[17] 11 U.S.C. §362(a).
[18] 11 U.S.C. §101(5).
[19] 11 U.S.C. §507.
[20] Id.

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In bankruptcy, to the extent the value of collateral securing a lender's claim is less than the amount of the claim, the lender's claim is bifurcated as to "secured" and "unsecured" portions:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property….and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.[21]

A lender with a $20 million debt secured by real estate and other collateral worth $15 million thus has a secured claim of $15 million and an unsecured claim of $5 million. In bankruptcy, that portion of a lender's claim which is secured will be repaid ahead of that portion which is unsecured, and payments a lender receives in a non-consensual Chapter 11 will largely determined by the value of the secured portion of its claim.[22] A lender who is "over secured" is also entitled to post-petition interest and attorneys' fees as provided in the agreement.[23]

A lender's ability to establish the highest value for its secured confers certain advantages, particularly if the lender is over secured, i.e., collateral value exceeds the amount of the debt.[24] If the borrower (or a junior lender) disputes the value the lenders assigns to the collateral securing its claim, as is often the case, then the bankruptcy court will hold an evidentiary hearing to make that determination.

The value of collateral in bankruptcy must be determined "in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.[25]" Thus, the value of collateral proposed to be liquidated may be determined differently from collateral which will continue to be utilized in operations.

The importance of collateral value in bankruptcy demonstrates the importance of the lender's early due diligence in evaluating collateral and obtaining appraisals from experts qualified to testify at any valuation hearing.

Cash collateral. Bankruptcy law affords special protections to a lender with an interest in "cash collateral," defined as rents or other "cash equivalents" pledged as security for a debt:

[21] 11 U.S.C. §506(a)(1).
[22] Under, 11 U.S.C. § 1129 (b)(2), to be confirmed, a Chapter 11 plan must provide for deferred payments to secured creditors totaling at least the value of their secured claims (i.e., the value of the collateral) as of the plan's effective date.
[23] 11 U.S.C. §506 (b).
[24] On the other hand, being over secured is a two-edged sword, in that it may reduce the likelihood of entitlement to adequate protection payments, as discussed, infra.
[25] Id.

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> … "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property . . . title, whether existing before or after the commencement of a case [26]…

After the filing of a bankruptcy case, a bankrupt borrower still operating its business is not permitted to continue to use the lender's cash collateral without court approval. It:

> "may not use, sell, or lease cash collateral … unless—
> (A) each entity that has an interest in such cash collateral consents; or
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.[27]

Until the Court issues an order permitting use of cash collateral by the borrower in Chapter 11, it is required to "segregate and account for any cash collateral in [its] possession, custody, or control.[28]"

Since the borrower will most likely need cash collateral to operate, motions to use cash collateral are usually filed by the bankrupt borrower on the first day of its bankruptcy. The lender may and often should file a cross-motion requesting that conditions be imposed on the borrower's use of cash collateral as necessary to provide it with adequate protection for its interest.[29]

Adequate protection. A primary purpose of Chapter 11 reorganization is to maximize the benefits to creditors generally by preserving the debtor's value as a going concern. If the debtor establishes the need to use the cash collateral to fund operations and preserve its going concern value, a motion to use it will usually be granted, subject to adequate protection for the lender. The debtor will generally present (and the lender should require) a detailed budget as to its proposed use of cash collateral.

The concept of "adequate protection" means protecting the lender from a decrease in the value of the collateral which it would otherwise be entitled to recover, but for the bankruptcy resulting in the borrower's continued utilization of same. In other words, the lender should not suffer a reduction in the value of its secured claim as a result of the debtor's use of the collateral.

Adequate protection often involves regular payments to the lender, for example interest payments, and may include a requirement that the cash collateral be used only for insurance and/or other expenses associated with preserving and protecting the property and income-

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[26] 11 U.S.C. §363(a).
[27] 11 U.S.C. §363 (c)(2). Although the statute refers to use of cash collateral by "the Trustee," in a Chapter 11 case, the debtor in possession has the rights and is required to perform the functions of a bankruptcy trustee. 11 U.S.C. §1107(a).
[28] 11 U.S.C. §363 (c) (4).
[29] 11 U.S.C. §363 (e).

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producing operations of the debtor related to it. Note that the over-secured creditor may be less likely to receive adequate protection payments as the court may deem that the "equity cushion, " i.e., the amount by which the collateral value exceeds its claim, sufficient to protect its interests.

During the workout planning process, the lender and counsel should evaluate the value of collateral (other than cash) securing its claim, and consider different methods of valuation based on its potential disposition or use in bankruptcy. Although the temptation to execute on cash collateral may be strong, unless the cash is in immediate danger of dissipation, the ability to obtain adequate protection to compensate it for its loss of same, may caution against such action, especially if the lender wants the borrower to survive to maximize value, and believes survival is possible.

Ideally, the workout should be structured so that, to the extent the borrower retains non-cash collateral, that collateral's value will be maximized in bankruptcy. It may make sense for the lender to permit the borrower access to cash collateral needed to operate the property which the lender does not wish to acquire, subject to approval of a budget and appropriate reporting requirements, audit rights, and other steps as necessary to safeguard it from dissipation.

Financing the bankrupt borrower's operations. If the borrower/Debtor-in Possession ("DIP") needs additional financing ("DIP financing") to continue operating in bankruptcy, a pre-petition lender might consider providing DIP financing on conditions requiring repayment of prepetition debt is made in the bankruptcy. This is controversial and may be subject to attack by other secured lenders as unfairly preferring the DIP lender. However, if the lender and borrower can show that no other financing is available and that the financing is in the best interests of all creditors, it may pass muster.

As with enforcement litigation, a bankruptcy filing may provide an ideal framework for negotiating and executing a workout agreement, providing all benefits of a state court setting, and in addition, the possibility of stay relief, limitations on debtor's ability to use or sell assets without court approval, Chapter 11 plan requirements, and the ability to deal with all creditors, as well as equity interests at the same time.

C. Mitigating the risk of claims to avoid payments as preferences. During the workout process, the lender and counsel should also attempt to mitigate the risk that transfers of collateral, payments, and new obligations incurred by the borrower in the workout will be subject to claims in bankruptcy to avoid them (i.e., require the lender to repay them to the debtor's estate) as preferential transfers.

The transfer of any interest in property of the debtor to a creditor for antecedent debt (debt owed before the transfer), made "while the debtor was insolvent[30]," and within 90 days of a bankruptcy filing,[31] which "enable the creditor to receive more than it would receive" if the case was a Chapter 7 liquidation and the transfer or payment had not been made, may be "avoided" by

[30] For purposes of preference claims, "insolvency" is presumed for the 90 day period preceding a bankruptcy filing 11 U.S.C. 547 (f).
[31] (one year if the creditor was an insider) 11 U.S.C. §547 (b)4(B).

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the trustee (or the debtor in possession), subject to certain defenses.[32] In other words, the creditor who received the transfer or payment may be sued in bankruptcy by the borrower or trustee to recover the payment.

Therefore, payments or transfers of the borrower-in-default's property to the lender may be subject to avoidance actions to recover them as preferential, subject to certain defenses.[33] For example, a transfer or payment to a lender may not be avoided as preferential under Section 547 if, inter alia:

- the transfer was intended by the debtor and lender to be "a contemporaneous for new value given the debtor," and the transfer was, in fact, in fact "a substantially contemporaneous exchange,"[34] or
- to the extent that after the transfer, the lender gave the debtor "new value" which was not secured by an otherwise unavoidable security interest, and on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. [35]

In structuring a workout, the lender and counsel should be aware that debt reduction or surrender of collateral to the lender on a loan in default may create claims for avoidance of the payments or transfers as preferential. Therefore, agreement should be sought from the borrower that it will not seek to set aside the transfers in bankruptcy as preferential. However, if a borrower's Chapter 11 case is converted and a trustee is appointed, these agreements may not be enforceable against an appointed trustee.

Even with careful planning, it may not be possible to eliminate all risks of preference avoidance claims which could arise in bankruptcy after a workout. If the choice comes down to the opportunity for the lender to receive a payment or surrender of collateral which will otherwise be lost or not receiving it, accepting the risk of an avoidance action is usually better than not receiving the payment at all.

VI. The Pre-Workout Agreement and Final Workout Agreement

The "Pre-Workout" Agreement. To the extent workout negotiations take place before the filing of enforcement litigation or a bankruptcy case, a "pre-workout" agreement to enter into negotiations is advisable to prevent communications occurring during such negotiations from creating new borrower defenses.

If litigation or bankruptcy is in process, a pre-workout agreement is not necessary, as long as the parties agree that the negotiations shall be treated as confidential and inadmissible

[32] 11 U.S.C. §547 (b)(c).
[33] 11 U.S.C.§547(c) lists all defenses to preference claims. Only those thought to be most relevant to prepetition payments by a borrower to a lender in a workout are listed here.
[34] 11 U.S.C. §547 (c)(1).
[35] 11 U.S.C. §547 (c)(4).

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settlement negotiations. If the lender has not commenced litigation or bankruptcy has not been filed, then without such an agreement and the protection afforded in litigation for settlement communications, a desperate borrower may argue that the lender agreed to waive defaults, rights or otherwise modify the loan.

The pre-workout agreement may be entitled "Agreement to Enter into Workout Negotiations" or something similar. In it, the lender should attempt to obtain recitations, some of which will be incorporated in the final workout agreement, that:

A. the borrower and lender are parties to the loan and security agreement and other loan documents (and if the borrower will agree), that the documents are valid and enforceable according to their terms);

B. the loan is in default and the events of default (if the borrower will agree, the amount owed should be included);

C. the borrower and the lender wish to engage in settlement negotiations regarding the defaults under the loan;

D. the content of the settlement negotiations will be privileged and inadmissible against both parties, and that neither the lender's engagement in settlement negotiations nor any communications made in the course of those negotiations may be deemed to constitute a waiver by the lender of any rights provided under or modification of any of terms in the loan agreement, which shall not be considered modified absent execution of a formal written modification agreement;

E. participation in settlement negotiations shall not prejudice the lender in any manner, or create any defenses in the event of subsequent litigation or bankruptcy;

F. if the settlement negotiations result in an agreement for resolution of the defaults acceptable to both parties, a formal, written loan modification agreement will be executed setting forth the terms;

G. if settlement negotiations do not result in an agreement for resolution of defaults acceptable to the lender within such defined time period as the lender may elect, the lender may exercise all rights provided under the loan documents as if the negotiations did not occur.

<u>The Final Workout or (Forbearance) Agreement.</u> Workout agreements typically involve some form of forbearance on the part of the lender in exchange for agreements of the borrower to offer collateral and/or make other concessions which will simplify the lender's ability to foreclose after future defaults.

The terms of final agreement, which may have a title similar to "Forbearance Agreement and Amendment to Loan and Security Agreement" are limited only by the imagination of

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lender's counsel applied to the facts at hand. Generally, the final workout agreement will include (A) and (B) above, and should or may also include:

C. Acknowledgement by the borrower and guarantors of the amount of the debt and details of any modifications in payment obligations;

D. Reaffirmations by the borrower of the validity of and provisions contained in the loan documents except to the extent modified by the agreement;

E. Identification of any additional collateral offered as security to the lender in the workout;

F. Clarifications or modifications needed to strengthen the lender's interest and the borrower's duties which respect to existing collateral, for example, increased audit rights for the lender and reporting duties for the borrower;

G. The borrower's waiver of all defenses and counterclaims purported existing to date;

H. Consent of any guarantors, and, if applicable additional guaranties;

I. Default and enforcement provisions;

J. Terms for disposition of collateral on default, including an agreement to a specific method for collateral disposition as commercially reasonable;

K. Specification of the forbearance the lender is granting in exchange for the borrower's new covenants;

L. Terms for streamlined or fast-track enforcement of remedies on subsequent default by the borrower and enforcement litigation;

M. Terms which will apply in the event of bankruptcy, for example:

- agreements to consent to stay relief and/or surrender with respect to certain collateral;
- agreements as to what will constitute adequate protection;
- stipulations as to the value of collateral for claims valuation purposes;
- agreements that payments or transfers of other property in the workout shall not be subject to avoidance as preferential by the borrower as debtor-in-possession.

While a bankruptcy court may not enforce all of these terms, they are nevertheless worth including as evidence of the borrower's intent, and as potential admissions against interest.

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If the workout occurs in the context of enforcement litigation, the terms may also be incorporated into a settlement stipulation approved by the Court, and may provide the lender with additional remedies such as entitlement to immediate foreclosure judgment after default.

VI. Conclusion

The goals of a successful workout should be maximum recovery, strengthening the lender's collateral position and rights, reduction of loss and other risks, and avoidance of the expense of protracted litigation (even if litigation is initiated to bring the borrower to the table). In exchange for this additional certainty and strength, time and/or other concessions may be granted to the borrower which make practical sense for the lender after careful analysis of the factors discussed above in each particular situation. Additionally, the successful workout should better position the lender to enforce its rights and remedies in court without a long battle should the borrower default after the restructure.

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