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The Practical Lender

Finance and Transactions Group

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Commercial Loan Workouts from the Secured Lender's Perspective

The uncertain economic times and high leverage multiples on many loan transactions have combined to create distress in many commercial loan portfolios. An understanding of commercial loan workouts is integral to loan officers, portfolio managers and internal lenders' counsel.

Every loan workout of a distressed company is distinct. Numerous factors drive the secured lender's strategies and tactics, including whether the borrower has a sustainable core business, strength of management, the type and value of the lender's collateral, cash flows, industry strengths and weaknesses, junior debtholders and lienholders and the potential effects of a Chapter 11 bankruptcy proceeding. These factors and others affect the strategies and leverage of a secured lender in taking action to protect and assert its rights and interests, as well as its ability to structure an exit strategy.

No single strategy is effective for every workout situation. Lenders, workout counsel and consultants must be prepared to roll with the waves and change their strategies and tactics. However, certain steps should be considered in most workouts by a secured lender. In this bulletin, we discuss these steps from the perspective of a secured lender in a workout of a distressed borrower.

Head in the Sand

Distressed borrowers tend to hope that financial problems will go away and solve themselves over time. Secured lenders often do the same when issues surface with their borrowers. Seldom, however, do such problems solve themselves without special and immediate attention. Red flags—such as declining cash flow and sales, loss of major customers, ineptitude or changes in management, failure to meet budgets and projections, requests for over-advances, borrowing base issues and failure to pay as agreed—require immediate explanation, evaluation and attention. If management's explanations or the secured lender's field audits do not provide adequate explanations and solutions to the issues, independent workout consultants should be retained, as discussed below.

Retention of Experienced Workout Consultants

Experienced workout consultants are critical to a successful workout and restructuring of a distressed borrower. Too often, a secured lender and/or borrower will delay the retention of a consultant, unwilling to incur additional costs. However, the cost of a secured lender's consultant typically can be added to the outstanding debt, and the consultant may later be a critical witness for the secured lender in a bankruptcy proceeding or litigation. An experienced workout consultant retained by the borrower can produce cash savings that more than cover the retainer agreement. The consultant should examine special issues such as unfunded pensions, leases, long-term contracts, litigation, cash flows and management issues. Advice in these areas can dramatically improve the results of a workout. Secured lenders should always consider having their counsel retain the consultant in order to potentially protect the consultant's work product as Attorney Work

Product. At times, a secured lender may require its borrower to retain a consultant as a condition to further lending under a forbearance agreement, as discussed further below. Whether retained by the secured lender or borrower, an experienced workout consultant can provide significant value. However, it is important that the scope of work and fees be addressed in advance to minimize disruption to the borrower's operations and to keep costs as low as reasonably possible, so the borrower benefits from the process.

Documentation and Collateral Perfection Analysis

Prior to proceeding with a workout, a secured lender and its counsel should always perform a documentation and collateral perfection examination. Updated Uniform Commercial Code, tax lien and judgment lien searches should be performed on an urgent basis at the beginning of a workout. Security and loan agreements, landlord waivers, deposit account control agreements, intercreditor agreements and guarantees should be examined to assure that all executed copies are in the file. Perfection on special collateral, such as trademarks, patents and other intellectual property, in addition to causes of action of the borrower in litigation, should be examined. Secured lender's counsel should also examine whether any delays in perfection might cause any concerns that the secured lender's liens could be avoided as a preference or fraudulent conveyance in a bankruptcy proceeding. Finally, the effects of a bankruptcy proceeding on the rights of the secured lender should be examined and considered by the secured lender and its counsel in forming the strategies for the workout.

Collateral Review, Analysis and Valuation

Field audits of inventory, accounts receivable and equipment should be performed to assure the accuracy of the borrower's borrowing base and other collateral reports. The potential of obtaining additional liens on unencumbered assets and second liens on collateral in which another party has a lien should be considered as consideration for continued lending.

Going-concern and orderly liquidation appraisals should be considered in the event of a bankruptcy proceeding or foreclosure. The retention of the appraiser by secured lender's counsel should be considered in order to potentially protect the appraiser's report as attorney work product. All of the above should be completed in order to help the secured lender, its counsel and other advisors form a strategy going forward, both in and out of a bankruptcy proceeding. The secured lender and its advisors should develop a special strategy for any "icebergs," i.e., collateral that deteriorates without the ability to move it.

Cash Flow Budgets and Projections

Short-term (four weeks, thirteen weeks) and long-term cash flow budgets and projections should be performed by the borrower and tested by the secured lender and its advisors to determine what additional over-advances or funds from equity or other interested parties are necessary to accomplish the restructure. "Budget-to-actual" reports should be required on at least a monthly basis in order to assure budget compliance.

Forbearance Agreements

Forbearance agreements are often requested by distressed borrowers during the restructuring period to avoid interruption by the secured lender. However, a properly drafted forbearance agreement can also provide significant benefits to the secured lender. The following benefits to the secured lender should be considered in the forbearance agreement:

- acknowledgment by the borrower of the outstanding balance, to avoid or reconcile any disputed balance
- acknowledgment by the borrower of specific current defaults and the

right to accelerate, to avoid future disputes or defenses regarding defaults (defaults should be waived only in rare instances)

- acknowledgment by the borrower that it has requested the forbearance, to establish consideration for any concessions to the secured lender
- establishment of a "forbearance termination date" or "drop dead date," by which the borrower must resolve certain issues (i.e., over-advances, refinancing, covenants, defaults or sale of the business or division)
- amendments to the loan agreement, such as reducing the amount of the loan commitment, increasing the interest rate or providing forbearance fees
- acknowledgment that the secured lender has a valid and properly perfected security interest, without any defenses
- acknowledgment by the borrower that the loan agreement is enforceable, without defenses
- full release and waiver of defenses by the borrower
- conditions of the forbearance, such as:
  - retention of a workout consultant, who will provide regular status reporting to the secured lender
  - retention of an investment banker or broker to sell the business, or a division or certain assets on an agreed-upon schedule
  - liquidation of excess inventory
  - utilization of additional collateral, guarantees or credit support
  - execution of additional documents, giving the secured lender an opportunity to cure any document or lien perfection issues
  - additional fees and increased interest in consideration for the forbearance

The secured creditor should always avoid exerting excessive "control" over the operations of the borrower, to avoid a claim of equitable subordination to other creditors or becoming a "responsible person" for taxes or environmental claims. For example, a secured creditor should never force or tell a debtor to pay or not pay other specific creditors.

Credit Support

Guarantees, letters of credit and other modes of credit support such as "last out" participations in favor of the secured lender, which may have been refused at the loan inception, may be obtained from equity owners in a restructuring. Guarantees, letters of credit and certain other types of credit support are not affected by the automatic stay in the event of a bankruptcy proceeding (discussed below) because they represent third-party agreements between the secured lender and a nonborrower third party.

Junior Debt and Lienholders

If there are junior debtholders (e.g., mezzanine debt) and/or second lienholders in the picture, a workout gets more complicated. The first thing a senior secured lender must do is review the protections and flexibility afforded to it under intercreditor agreements and subordination agreements including the ability to block payments, standstill periods on the ability of junior creditors and lienholders to assert remedies, and the ability to sell assets and require junior lienholders to release collateral. However, the senior secured lender must also examine the limits on its flexibility under those same agreements such as senior debt caps, limitations on amendments to the senior debt documents and restrictions, if any, on the ability to provide debtor-in-possession financing or permit the use of cash collateral in a bankruptcy proceeding.

In transactions with multiple layers and tranches of debt, the senior secured creditor (particularly on cash flow loans or asset-based "stretch" loans) will need to recognize the reality that waivers and forbearance terms with borrowers may be futile without the junior lenders and lienholders having a "seat at the table" and agreeing to terms acceptable to them.

In a "meltdown" situation where the interests of the various tranches are no longer aligned and there is no clear path to an exit, the senior secured lender will need to address a variety of competing forces and hostilities. Well-drafted and thought-out intercreditor agreements and subordination agreements at the outset of a transaction are integral to keep the liens and claims of junior debtholders and lienholders behind the Interests of the senior secured lender.

Pre-Bankruptcy Remedies

All realistic pre-bankruptcy proceeding remedies should be considered by the secured lender, its counsel and advisors. This includes:

- Reservation of rights
- Notice of default
- Acceleration of all obligations
- Uniform Commercial Code foreclosure on personal property collateral
- Real estate foreclosures
- "Friendly" foreclosures, where the borrower surrenders the collateral to the secured lender

In all events, the secured lender should assert only those rights provided "within the four corners of its documents" and applicable law, to avoid claims by the borrowers and other creditors such as "equitable subordination" or the much-maligned theory of "deepening insolvency."

Potential Actions of the Borrower

All potential actions of the borrower should be anticipated and considered by the secured lender internally with its counsel and advisors, and then discussed and considered with the borrower. This includes:

- Out-of-court restructuring, including concessions by both the secured and unsecured creditors
- Assignments for the benefit of creditors—an orderly state law process whereby all assets are transferred to an independent third-party trustee, who performs an orderly liquidation and distributes the proceeds in accordance with the priorities of law (often different from state to state)
- Liquidation under state law—the borrower and its advisors perform an orderly liquidation under the corporate laws of the applicable state statute
- Chapter 11 reorganization under the U.S. Bankruptcy Code, discussed further below
- Chapter 7 liquidation (as opposed to a reorganization) under the U.S. Bankruptcy Code, performed by an independent trustee appointed by the Bankruptcy Court

Chapter 11 Reorganization Under the United States Bankruptcy Code

The Chapter 11 reorganization process under the U.S. Bankruptcy Code is complicated and requires a more detailed discussion than what is provided in this bulletin. However, certain aspects of a Chapter 11 proceeding can be highlighted. A Chapter 11 proceeding is extremely expensive and should typically be considered only as a remedy of last resort. Counsel and advisor fees and expenses for the debtor-in-possession, creditors' committee and secured lender can significantly erode the value of a secured lender's collateral. Further, damage to the debtor's going concern through loss of customers, loss of management and sales force, loss of credit and refusal of account debtors to pay ("hiding behind the trees") can erode a secured lender's collateral. However, certain protections to the debtor-in-possession may help the borrower restructure its obligations and enhance its going-concern value as a reorganized debtor:

- the automatic stay—creditors are prevented from collecting amounts owed by the debtor, foreclosing on the debtor's collateral and terminating contracts
- at least initially, the debtor cannot pay any unsecured creditors that existed as of the commencement of the bankruptcy
- expensive litigation against the debtor can be stayed
- the debtor is allowed to assume the contracts it desires and reject the contracts it considers burdensome

Although a secured creditor is initially stayed from asserting its rights by the automatic stay, the U.S. Bankruptcy Code provides significant protections to the properly perfected secured creditor:

- the ability to obtain additional collateral, super-priority administrative claims, fees and increased interest for providing debtor-in-possession financing
- adequate protection for the debtor's use of the secured lender's collateral, by replacement liens, principal and interest payments, payments for deterioration of collateral and assurance of proper insurance and security of its collateral
- proper court approval of the reasonable process for sales of assets out of the ordinary course of the debtor's business
- the ability to obtain financial information and inspections that were not provided by the debtor outside of the bankruptcy proceeding
- court-ordered control of the debtor's expenditures pursuant to a court-approved budget

Conclusion

A distressed borrower's financial problems rarely solve themselves. Early, proactive involvement of a secured lender in a workout situation, with the advice of experienced insolvency and workout counsel and consultants, is more likely to result in a successful exit.

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