SUCCESSFULLY NAVIGATING MURKY WATERS FOR DISTRESSED LOANS

BEST PRACTICES FOR LENDERS

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Since the start of the economic crisis, credit markets have tightened, companies have struggled to survive, loan defaults have risen exponentially and lenders have been faced with decisions on whether to attempt a workout of a loan relationship or to begin exercising rights immediately, being always cognizant that a bankruptcy may be looming. This article examines strategies lenders should employ to successfully navigate these murky waters for commercial loans secured by personal property collateral.

Strength of Collateral

A lender's strategy will often be dictated by the type and value of a lender's collateral. Early in the process, the secured lender should review the security documents to confirm the existence, priority and perfection of the lender's lien on collateral. The lender should also verify that the security agreement (and other documents) are properly executed by the debtor and that there are no blanks or missing exhibits. When evaluating the collateral, lenders should obtain UCC reports, title searches, and judgment and lien reports.

The lender should verify that the financing statement is filed in the correct place. For most personal property collateral, the filing must occur in the state of organization or incorporation of the debtor. Financing statements expire after five years unless a continuation statement is filed within six months prior to the expiration date of the original financing statement or a previously continued financing statement. The lender should verify that the financing statement contains the correct name of the debtor. The financing statement should have the official name listed on the organizational documents filed with the state. Trade names are unacceptable.

Confirm that the collateral is adequately described. The security agreement may not list the collateral as "all assets," but "all assets" is a permissible description for the financing statement if the debtor is providing a blanket lien on assets. For the description of inventory or equipment, it is important to remember that the collateral must be described based on how it is used by the debtor. For example, if the debtor is the seller of heavy equipment, the equipment it holds for sale should be described as "inventory," not "equipment."

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If the collateral is inventory or equipment, the lender needs to ascertain whether the lender's file sufficiently identifies the collateral. State law may provide a judicial remedy (for example, a replevin action in Maryland) to obtain possession of the lender's tangible collateral in the event the debtor refuses to deliver possession of the collateral. However, this type of remedy may be unavailable if the lender is unable to provide an adequate description of the property (e.g. type, model and quantity of the collateral inventory or equipment) and the value of the property.

Current accounts receivable and accounts payable agings should be obtained from the borrower. They should be reviewed for trends, concentrations with a particular customers, ineligible receivables and compliance with borrowing base requirements.

As a general rule, once a lender identifies any deficiency with its collateral it should attempt to remedy the deficiency. However, the lender should be cognizant that delays in granting a security interest or perfection of a security may result in the lien being avoided as a preference if the transfer occurred within ninety days of a bankruptcy filing. In the unfortunate situation where a bankruptcy court determines a lender is an insider of the debtor, the look back period for preferences is one year.

If the lender can work with the borrower, entering into a forbearance agreement provides the lender with time to cure the deficiencies and may be preferable to litigation, which is more likely to result in a bankruptcy during the preference period. The same issues arise in taking additional collateral or junior liens on property as a part of a forbearance arrangement. If properly structured, the forbearance period should extend beyond the preference period. Sophisticated obligors may request an agreement tolling the preference period if they realize deficiencies exist in the security documents.

Review the Loan Document

Beyond the security documents, the lender will want to examine other documents such as guarantees and obtain updated financial statements from all obligors. The current financial statements of all obligors may highlight additional collateral that can be obtained to secure the indebtedness. Even if the lender is unable to obtain additional collateral in a workout, learning the identity, location and other pertinent information regarding tangible assets owned by the obligors may prove useful in executing on a judgment. For example, if the debtor owns stock, the method of executing on the stock differs depending on whether the stock is certificated or uncertificated. Therefore, it is important to know whether the stock is certificated or uncertificated, the location of the stock if it is certificated, and the chief executive office of the issuer if it is uncertificated so that the writ of attachment can be properly served.

Current financial statements should be compared with prior financial statements to determine whether any assets have disappeared. If the obligors are unable to provide a satisfactory explanation, this may impact the lender's approach to the borrower and other obligors.

The lender will need to review guarantees to determine whether they are unlimited, and, if they are not, what recourse the lender has against the guarantors. Now is also the time to ascertain whether there are additional guarantors that can add value to the relationship.

Know Your Borrower and Guarantor

Identify the causes of the borrower's financial problems. Ascertain what external factors may have played a part in the deterioration of the loan. Central to any strategy will be an evaluation of the management of the borrower. Is the current management competent? Can the current management be trusted and have they been forthright? Evaluate the current operations of the borrower and whether the borrower is viable. Critical to a successful workout is competent management, a viable product and financial resources.

Meet on site with the borrower. Meet with the borrower at the place of business to determine the condition of the business operations and the collateral. Plant visits and monthly reporting provide an opportunity to determine whether the borrower is engaged in deceptive or fraudulent practices. Conduct or hire a consultant to perform field audits of the inventory and equipment conducted. Equipment and inventory should be appraised at "market," "in place," "orderly liquidation" and at "fire sale" values. Adjustments should be made for obsolete or ineligible items of inventory. Meet with key members of the internal accounting team and external accountants for the borrower.

Obtain short term and long term budgets from the borrower. As part of any forbearance arrangement, the borrower should be put on a budget and provide monthly reporting as to compliance with the budget. The borrower should provide on a monthly basis:

1. profit and loss statements;
2. accounts receivable reports, accounts receivable agings, accounts payable reports and accounts payable agings; and
3. budget variance reports.

Review the Administration of the Loan

The lender should review the lender's internal communications regarding the loan and communications with the borrower and any other obligors to gain both the history of the loan and the relationship of the parties. The lender should identify any communications that could be detrimental to the lender in litigation with the obligors. Remember, internal emails can be subpoenaed by the borrower. The file should be reviewed for side letters and consents that deviate from the loan documents. If there is a course of dealings waiving defaults or foregoing the enforcement of covenants in the loan documents, the lender may need to give the borrower reasonable notice before enforcing these provisions of the loan documents. This supports the notion that the earlier the lender can identify the problems, the more likely the lender will be able to fix them before finding itself in litigation with the obligors.

Communications should be centralized so that borrower cannot do an "end run" around the asset manager or special assets department entrusted with preparing and executing a plan. For consistency, all negotiations should be handled by the same one

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or two representatives of the lender. The lender should avoid assurances that a work-out is possible. Conversely, the lender should avoid the appearance of a "knee jerk" reaction by declining even reasonable requests of the borrower. Ideally, early in the process the obligors will retain counsel so that the lender's counsel can deal directly with the obligors' counsel.

Forbearance Agreements

If a consensual workout may be feasible, the lender should consider entering into a pre-negotiation agreement. The purpose of the pre-negotiation agreement is to clarify that unless final documents are executed, no oral agreements are enforceable, discussions are strictly settlement communications and are not discoverable, and the lender is not foregoing other options. Although Md. Code Ann., Cts. & Jud. Proc. §§ 5-408, *et seq.* provide that as to financial institutions[1] oral modifications of commercial credit agreements or oral promises to forbear from collecting such a debt or exercising remedies are unenforceable, it is still a good practice to enter into a pre-negotiation agreement so that the expectations of the parties are clear during negotiation of a forbearance agreement.

Certain key terms of any forbearance agreement are:

- Acknowledgement by the obligors of the outstanding debt (principal, interest, late fees, etc.) and that there is no defenses, counter-claims or right of recoupment.
- A reservation of rights by the lender against all obligors in the event of a default or the expiration of the forbearance period.
- Consent to the provisions of the agreement and ratification of the loan documents by all obligors.
- A broad release, which should include a voluntary relinquishment and waiver of all claims, counterclaims or the like, whether known or unknown, against the lender, its employees, officers, directors, affiliates, parent company and counsel.
- Waiver of a jury trial (this provision should be in bold print, conspicuous and near the signature lines).
- Confession of judgment as a remedy.

The forbearance agreement should not contain a provision prohibiting the filing of a bankruptcy because this type of provision is void as against public policy. Similarly, the agreement should not contain a waiver of the automatic stay of 11 U.S.C. § 362 with respect to any collateral as those type of clauses have been held to be unenforceable. Given the importance of the automatic stay in bankruptcy, some courts have refused to enforce provisions in forbearance agreements consenting to stay relief as a matter of public policy. Although bankruptcy courts uniformly agree that these provisions are not self-executing or per se enforceable, the trend among courts is in favor of granting relief from the bankruptcy stay when a debtor has agreed to consent to relief from the stay, or agrees not to raise defenses to a lift stay motion if certain factors weigh in favor of the creditor. In Maryland, the factors reviewed by the bankruptcy court in determining whether to enforce the waiver are:

- Sophistication of the party making the waiver.
- Proximity in time to the bankruptcy.
- The consideration by the lender, including whether there were substantial concessions by the lender and whether the lender assumed risk.
- Feasibility of the debtor's plan.
- Whether other parties with legitimate interests in the bankruptcy affected (e.g. large unsecured class, subordinated leases, employees).

At a minimum, if a forbearance agreement contains a provision consenting to the lifting of the stay or an agreement not to raise defenses to a lift stay motion, in certain jurisdictions including Maryland, this may be considered as a factor in deciding if cause exists to lift the automatic stay.

Final Analysis

When a loan or a lending relationship becomes troubled, early intervention is the key to a successful strategy. Ascertaining the competence of the borrower's management and the viability of the borrower are necessary to formulate a plan. Because the lender will have the greatest leverage if it is well collateralized, an analysis of the type and value of the collateral must be performed early in the process. During this process any collateral deficiencies should be identified and remedied, if possible. If additional collateral or guarantors can be provided to strengthen the lending relationship, or if loan document deficiencies can be cured, these factors may weigh in favor of attempting to achieve a forbearance arrangement with the obligors, rather than immediately enforcing the lender's default remedies. If a forbearance arrangement is feasible, the agreement should contain certain essential terms (identified in previous section) to help protect the lender in the event of a default or bankruptcy. A consistent plan and a well informed lender has the greatest ability to minimize loss when a good loan goes bad.

[1] Both "financial institution" and "credit agreement" are defined in Md. Code Ann., Cts. & Jud. Proc. § 5-408.

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