Counsel to Counsel

What to do When the Bank Comes Knocking at Your Door

by Timothy Duggan

Over the years, I have negotiated and litigated with many borrowers, guarantors and lawyers, all of whom seem to have a different approach to dealing with defaulted loans. Although the success of a matter often depends on factors outside the control of counsel (*i.e.*, market conditions, management problems, lack of additional sources of cash), most attorneys with experience negotiating distressed loans understand the importance of addressing the realities of the situation and what does (and does not) work. This article provides an overview of the more important issues and challenges attorneys face when negotiating a commercial workout or loan modification with a lender.

When and How to Approach Your Lender

The downturn in the economy has caused many businesses to become more efficient by cutting costs and scaling back operations. However, when sales are not coming in and the accounts receivable are moving from the 60-day column to the 90- or 120-day column, cash flow may not be able to cover all expenses, including debt service. When an honest look at the financial statements shows a loan default is on the horizon, many borrowers are reluctant to approach their lender prior to a default to discuss the situation and address their cash flow problems. Why? In my experience, the borrower is either overly optimistic and believes the economy will turn the corner before a default, or the borrower has his or her head in the sand and is ignoring the reality of the situation. Of course, there are other reasons, but these two seem to arise most frequently.

Borrowers need to consider approaching their lender before an event of default for several reasons. First, although the financial statements may look bad, going to a lender with the bad news gives the borrower a certain amount of credibility, and demonstrates to the lender that management is attempting to address the financial issues, not ignore them. What is crucial to the workout process is trust and honesty, both in written and verbal form. Second, the lender will find out sooner or later. Delaying the inevitable will not help, unless there is a specific reason to wait (which is the case under certain circumstances). Also, you will have time to prepare for a meeting, and can retain competent professionals (a lawyer or accountant) to assist in the process. If a lender shows up at the borrower's business demanding to see updated financial statements, the borrower will be under pressure to produce something. That 'something' may not be accurate, and will start the process off on the wrong foot. Proper planning is crucial.

Important First Steps

Communication is one of the most important parts of a successful workout. Too often, I receive a call from a lender asking me to get involved in a matter because the borrower is not returning his or her phone calls. More often than not, a borrower experiencing financial problems will not return calls from the lender, which is an immediate red flag. Understandably, the borrower does not want to convey bad news to the lender, but the lack of response is a clear indication of a significant problem, and will only make matters worse. Further, it does not develop trust, and may call into question the competency of management. Opening a line of communications is crucial.

Lenders also lose trust in a borrower when promises are made and not kept. If a borrower is going to promise current financial statements by a certain date, make sure the financial statements arrive on time. Do not promise payments the borrower cannot make. Borrowers will often seek to buy time by

telling a lender what he or she believes the lender wants to hear, as opposed to what the borrower believes it can do.

The borrower needs to prepare accurate and current financial statements, including accurate cash flow projections. The cornerstone of any successful workout is accurate financial information that will enable both sides to structure a satisfactory workout. Too often, a borrower will provide tax returns and financial statements that are six to nine months old. Lenders cannot make decisions based upon old financial statements. Also, borrowers cannot be overly optimistic with cash flow projections. Borrowers should expect their lenders to challenge the assumptions in cash flow projections. Often it is advisable to have the borrower's accountant attend the workout meeting.

Borrowers need to select the appropriate counsel, accountants and financial advisors. Experienced debtor's counsel generally know what are realistic alternatives in workouts, and will not waste time presenting proposals that will be met with a swift rejection. In addition, competent counsel and accountants can discuss alternatives to workouts, including Chapter 11 bankruptcy protection.

What is a Workout?

Workout plans vary depending upon the circumstances, and creative lawyers and accountants can present a variety of workout scenarios for a borrower. Do not expect to walk into a meeting and have your lender agree to reduce the principal balance simply because "banks would rather get something than nothing." The borrower must present a plan that is not only feasible, but makes sense to the lender.

Forbearance agreements are a common type of workout agreement. Generally, a lender will not waive defaults or any other rights in a forbearance agreement, but will agree to forbear from filing a lawsuit or taking any other action to collect the loan, subject to certain terms and conditions. During the forbearance period, the parties will generally negotiate a longer term arrangement, such as a loan modification. The lender will often require the borrower to make periodic payments and provide more frequent financial reporting (*i.e.*, biweekly financial statements), and waive any defense or claim against the lender. Accurate and current financial statements will enable the borrower to negotiate a reasonable payment plan during the forbearance period.

Not all lenders approach workouts in the same manner. For example, some lenders require a forbearance fee that can be a token fee ($1,000) or a significant payment ($10,000 or one percent of the principal balance). Other lenders will want draconian remedies if there is a default, including the immediate entry of judgment or the recording of a deed in lieu of foreclosure (discussed below). It is important to be aware of these issues before you start the negotiation process.

In states where foreclosures take a substantial amount of time (like New Jersey), lenders will often want to start and prosecute a foreclosure action during the forbearance period. It is not uncommon for a lender to require the borrower to consent to the filing of a foreclosure complaint, waive all defenses to the foreclosure action, and consent to the entry of judgment. The judgment will be held in escrow pending a default under the forbearance agreement. Although this remedy may seem draconian, lenders do not want to start the 18-month foreclosure process six or seven months down the road.

As an alternative, some lenders will demand that the borrower execute a deed in lieu of foreclosure. The deed will be placed in escrow, and upon a default under the forbearance agreement the deed will be released from escrow and recorded with the appropriate county clerk. When negotiating a deed in lieu of foreclosure, both parties need to understand the costs and potential problems with this remedy.

First, the deed in lieu of foreclosure will not foreclose any subordinate liens (*i.e.*, second mortgage, judgment liens, IRS lien, etc.), which often makes the remedy meaningless. If there are subordinate liens and the lender accepts the deed in lieu of foreclosure, the lender must still go through the foreclosure process to clear title. It is important for lenders to make certain the deed in lieu of foreclosure has the required 'anti-merger' language to avoid having the mortgage merge into the fee simple interest upon recording of the deed.

Second, the lender may be required to provide the state of New Jersey with a notice under the Bulk Sales Act. Failure to give notice may make the lender liable for certain types of unpaid taxes.

Third, if the mortgage is not discharged when the deed in lieu is recorded, the transaction will be subject to the New Jersey realty transfer fee, which must be paid when the deed is recorded.

Fourth, the value of the property will need to be addressed, since the borrower will need to receive some type of credit against the debt when the lender takes title to the property. If the issue is left open, the parties may incur costs later on, in the form of a 'fair market value hearing' to determine the amount of the credit.

Finally, the borrower should evaluate all tax consequences of the transaction, including whether or not the lender will be sending a 1099 form to the Internal Revenue Service to report debt forgiveness.

These are just some of the issues that arise in a deed in lieu of foreclosure transaction.

Chapter 11 Can Be a Good Solution

Bankruptcy can be an option that a lender finds acceptable. In troubled times, borrowers often find themselves accruing significant trade debt, most of which is

unsecured. When times get better, the old unsecured debt hampers a recovery, since valuable cash flow is being used for unproductive purposes. A Chapter 11 reorganization may be the solution.

An experienced bankruptcy lawyer can advise a borrower how a Chapter 11 can improve cash flow by discharging unsecured debt. Once discharged, there may be additional funds available to restructure a lender's secured claim. However, bankruptcy does not come with a magic wand that simply allows a borrower to wipe away debt without a downside; the process has stringent rules and is expensive. For example, a borrower may need the lender's consent to use cash generated from the collection of accounts receivable or rents.

Cash that is encumbered with a lender's lien is known as cash collateral, and is subject to restrictions in a bankruptcy case. Once in bankruptcy, new bank accounts must be opened (known as debtor-in-possession accounts) and monthly operating reports must be prepared and sent to the Office of the United States Trustee. Not surprisingly, the process is expensive.

Nevertheless, good pre-bankruptcy planning can enable a borrower to navigate a bankruptcy case and confirm a bankruptcy plan that is acceptable to a lender. To avoid the initial disputes over the use of cash collateral, it is almost always better to attempt to negotiate a cash collateral order with the lender prior to filing for bankruptcy protection. The order will generally allow the borrower to use limited cash for a certain time period (*i.e.*, 30 to 60 days), with both sides reserving their right to terminate or continue the arrangement. For this process to work, the borrower will need accurate financial records and a realistic cash flow budget.

There are several reasons why a lender would consider supporting a Chapter 11 bankruptcy filing. First, a borrower cannot transfer assets outside of the ordinary course of business without first obtaining a court order that prohibits the hiding of assets. Second, there is increased reporting in the form of monthly operating reports that enables a lender to closely monitor the borrower's business. Third, the lender can condition the use of its cash collateral and limit what expenses the borrower pays. Finally, it leaves open the option of a liquidating Chapter 11 plan that enables the lender to exit the relationship.

Facing Reality—Knowing When to Fold

Often the only real solution is a sale of assets to pay off the lender. However, the borrower and lender do not always agree on who should be in control of the liquidation process. Borrowers generally like to retain control in order to make certain maximum value is obtained for the assets. In addition, they often feel they know the market better than the lender. Lenders generally want the process to move quickly, and are concerned that borrowers will hold out for unrealistic prices.

What is the compromise? The parties can negotiate a sale process with certain incentives and protections. For example, a borrower may be able to negotiate a release for a guarantor if certain milestones are met. Lenders are looking for the maximum cash in the shortest period of time, while avoiding out-of-pocket expenses. However, this does not mean a lender will simply take the net proceeds of a sale and let the borrower and guarantor walk away from a deficiency; there must be something in it for the lender.

Dos and Don'ts for Counsel

The following dos and don'ts can help lawyers counsel their clients when answering the call of a lender.

Do be responsive and open lines of communication. Responsiveness starts building credibility with the lender. Once a relationship gets off on the wrong foot, it may never recover.

Do be prepared to meet with your lender by preparing accurate and updated financial statements. Lack of solid financial statements can immediately derail the process. The only way to move forward is to deal with reality.

Do be prepared to provide your client with an honest assessment of the situation, including communicating bad news. Let him or her know what is possible and what is not, and do not be afraid to give the 'facts of life' speech. False hope generally leads to bad results.

Do consider all options, including Chapter 11 (reorganization or liquidation), and develop a realistic plan. Think outside the box, but be realistic.

Don't believe everything you hear and read; lenders are not giving away the bank to avoid taking title to property. Lenders prefer to avoid the foreclosure process, but are not afraid to take title to property.

Don't let your client continue to use bad professionals. If financial records are a mess, change accountants.

Don't allow your client to wait until the last minute to make an offer or request a meeting.

Eventually, the economy will turn around and business will improve. Lenders hope their customers will survive, and generally want to resolve troubled loans. Borrowers need to assemble a good team of professionals to help navigate the workout process in the hopes of restructuring their debts to reach the good times. ⚖

Timothy Duggan *is a shareholder with the law firm of Stark & Stark, and chair of the firm's bankruptcy and creditor's rights group.*