

Commercial loan work-outs from the secured lender's perspective

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Every loan work-out 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, and the potential effects of a Chapter 11 bankruptcy proceeding. All 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 work-out situation. Lenders, work-out counsel and consultants must be prepared to roll with the waves and change their strategies and tactics. However, knowing certain steps and issues that should be considered in most work-outs is useful, if not essential, to a secured lender. In this chapter, we discuss these steps from the perspective of a secured lender in a work-out of a distressed borrower in the United States.

Head in the sand

Distressed borrowers have a tendency to 'stick their head in the sand', hoping that financial problems will go away and solve themselves over time. Secured lenders at times 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 work-out consultants should be retained, as discussed below.

Retention of experienced work-out consultants

Experienced work-out consultants are critical to a successful work-out 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 become a critical witness for the secured lender in a bankruptcy proceeding or litigation. An experienced work-out consultant retained by the borrower can produce cash savings that more than cover the retainer agreement. The consultant should further 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 work-out. Secured lenders should always consider having their counsel retain the

consultant so as potentially to 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 work-out consultant provides value that cannot be overstated.

Documentation and collateral perfection analysis

Prior to proceeding with a work-out, 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 immediately at the beginning of a work-out. 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 and commercial tort causes of action of the borrower in litigation, should be examined. Secured lender's counsel should examine whether any delays in perfection could 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 and its effects 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 work-out.

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 so as potentially to 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 advisers form a strategy going forward, both in and out of a bankruptcy proceeding. The secured lender and its advisers should develop a special strategy for any 'icebergs' (ie, collateral that deteriorates without the ability to move it).

Cash-flow budgets and projections

Short term (four weeks, 13 weeks) and long term cash-flow budgets and projections should be performed by the borrower and tested by the secured lender and its advisers in order 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 in order to avoid interruption by the secured lender. However, a properly drafted forbearance agreement can actually 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, in order to avoid or reconcile any disputed balance;
- acknowledgment by the borrower of specific current defaults and the right to accelerate, in order to avoid future disputes or defences regarding defaults. Defaults should be waived only in rare instances;
- acknowledgment by the borrower that it has requested the forbearance, in order to establish consideration for any concessions to the secured lender;
- establishment of a 'forbearance termination date' or 'drop dead dates', by which the borrower must resolve certain issues (ie, 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 maintains a valid and properly perfected security interest, without any defences thereto;
- acknowledgment by the borrower that the loan

agreement is enforceable, without defences thereto;

- full release and waiver of defences by the borrower; and
- conditions of the forbearance, such as:
 - retention of a work-out consultant, which 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;
 - liquidation of excess inventory;
 - adding 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; and
 - additional fees and increased interest in consideration for the forbearance.

The secured lender should always be careful to avoid exerting excessive 'control' over the operations of the borrower, in order to avoid a claim of equitable subordination to other creditors or becoming a 'responsible person' which is responsible for taxes or environmental claims. For example, a secured lender should never force or tell a debtor to pay or not to pay other specific creditors.

Guarantees and letters of credit

Guarantees and letters of credit in favour of the secured lender, which may have been refused at the loan inception, may be obtained in a restructuring. Guarantees and letters of credit 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 non-borrower third party.

Pre-bankruptcy remedies

All pre-bankruptcy proceeding remedies should be considered by the secured lender, its counsel and its advisers:

- reservation of rights;
- notice of default;
- acceleration of all obligations;
- Uniform Commercial Code foreclosure on personal property collateral;
- real estate foreclosures; and
- '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, in order to avoid claims by the borrowers and other creditors of '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 advisers, and then discussed and considered with the borrower:

- 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, which 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 advisers perform an orderly liquidation under the corporate laws of the applicable state statute;
- Chapter 11 reorganisation under the US Bankruptcy Code, discussed further below; and
- Chapter 7 liquidation (as opposed to a reorganisation) under the US Bankruptcy Code, performed by an independent trustee appointed by the Bankruptcy Court

Chapter 11 reorganisation under the US Bankruptcy Code

The Chapter 11 reorganisation process under the US Bankruptcy Code is extremely complicated and requires a more detailed discussion than that provided in this chapter. 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 adviser fees and expenses for the debtor in possession, creditors' committee and secured lender can further 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 salesforce, 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 reorganised 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; and
- 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 US 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; and
- court ordered control of the debtor's expenditures pursuant to a court approved budget.

Conclusion

Seldom will a 'head in the sand' strategy work, as seldom will a distressed borrower's financial problems solve themselves. Early proactive involvement of a secured lender in a work-out situation, with the advice of experienced insolvency and work-out counsel and consultants, is more likely to result in a successful exit strategy for the secured lender.