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LENDING

Detecting Signs and Taking Action When a Loan Default Is Imminent

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Picture this. You are a lender for a major financial institution when you discover the following:

• Loan payments are late.
• The borrower's financials are late.
• The borrower is not in compliance with its financial covenants.
• One of the borrowers' executive officers has left.
• Substantial litigation has been commenced against the borrower.

For the lender, these are clear signs of a deteriorating financial situation of the borrower which requires immediate action.

For the borrower, these should be the warning signs that the lender will shortly be taking action to protect itself if the situation continues to deteriorate.

Different loans give rise to different responses. Unsecured loans give the lender the fewest options and therefore a greater incentive to negotiate a restructuring of the loan. By the same token, unsecured loans give borrowers the greatest negotiating ability to restructure their loan under the threat of bankruptcy. The options under a secured loan depend on the type and value of the collateral.

The threat of bankruptcy always provides the borrower with a weapon which must be considered by the lender before taking any steps to enforce its loan.

Steps by the Lender

1. Assembling a team. Lenders should determine who will be the decision-maker for the loan, what decisions will have to be made and what will be the timetable. Within the team or company, it is important to identify the credit and collections personnel, asset managers and outside experts who will be required.

2. Evaluating how bad the situation is. If the lender already has a security interest in equipment, inventory or other collateral, it can audit and inspect that collateral. Another task would be to identify the location of all the collateral and determine if any has been moved. The lender can also go about obtaining the names of borrower's customers and the location of job sites where collateral may be used. An appraisal for the collateral to determine its liquidation value is also an important step.

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In a liquidation, would the proceeds satisfy the debt? If not, there is obviously more incentive to work with the borrower. Check the UCC financing statements to see that you have maintained perfection of your security interest in your collateral. Check who else may have filed UCCs and on what assets. Make sure that the debtor's insurance on its assets is in place, that the amount is sufficient, that the premiums have been paid and that you are named as loss payee so that your collateral is protected.

3. Determining leverage. Ordering UCC and litigation searches helps determine just how bad the situation really is. Can you demand additional collateral to secure the repayment of the debt? (Be careful of preference claims if additional collateral is granted and the borrower files bankruptcy within 90 days of your obtaining the additional collateral.) Do you have personal guaranties? Do you have a "bad boy" guaranty for a breach of prohibited actions? Contact the borrower's other creditors and determine whether the borrower is in default to such other creditors. Determine if any of the other creditors have rights in your collateral.

4. Evaluating the strength of the lender's position. Review your loan documents. It is often only after a default that a bank or financial institution will review its loan documents and discover errors or weaknesses in the original deal. For example,

(a) A guaranty was signed by an employee of the Guarantor and not the authorized signatory.

(b) The UCC-1 financing statement was never filed or no continuation statement was filed (UCC is only good for five years).

(c) The actual borrower is a holding company and only its subsidiaries—the operating companies—have assets.

(d) The subsidiary guarantors received no benefit for their guaranty and this guaranty is without consideration.

(e) The guaranty is silent as to whether the lender has to sue the primary obligor or liquidate collateral first.

If there are omissions or ambiguities in the original deal documents, restructuring that debt provides an opportunity to strengthen the lender's legal position.

5. Reviewing the administration of the loan; conferring with the relationship and asset managers. In the course of dealings with the borrower, did he show his hand regarding possible ambiguities or mistakes that the lender needs to correct? For example, were there actions taken in the administration of a loan which could be interpreted as waiving provisions in the loan documents or creating a new course of conduct between the parties different than conduct required by the documents, such as:

• "Don't worry, you can pay on the 15th of the month (not the 1st)."
• "You don't really have to give me quarterly financial statements—year-end statements will do."
• "Audited financial statements aren't necessary."

Moreover, a borrower's complaints can form the basis of a defense or counterclaim in a suit brought to collect the debt; the lender should investigate to uncover any outrageous facts or conduct in the administration of the loan. Did the borrower complain that the lender failed to perform? Is there any evidence of inappropriate conduct? For example, has the borrower claimed that a lender was exercising too much control over a debtor's business—i.e, by pressuring the debtor to hire a crisis manager or accountant of the bank's choosing or interfering with a debtor's relationship with other lenders or vendors? Such complaints have been the basis of claims for equitable subordination of a debt.

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These types of issues could pose subsequent problems in the enforcement of loan documents; restructuring agreements provide the opportunity to get rid of these kinds of claims.

6. Assessing potential deepening insolvency claims. These claims may be found if (1) an existing lender extends additional credit in exchange for additional security despite a borrower being financial troubled with little chance of recovery, and (2) a lender causes a borrower to remain in business for the benefit of the lender while the lender extracts value to the detriment of unsecured creditors.

If additional financing is offered, ensure that the risk of a borrower's insolvency is not increased to the detriment of unsecured creditors.

7. Evaluating the borrower. Can the company survive? Is it adequately capitalized? What are its short- and long-term cash needs? Review current financial statements and cash flow projections. Look the current management in the eye. Are they competent? Motivated? Honest? With respect to their current operations, are there financial controls in place? Are expenses out of whack? Has it lost their current market position? Is its product passé?

Identify the causes of the borrower's problems: Is there an extraordinary event at the core of the financial problems or are there ongoing issues? Determine if there is only a temporary business problem, like a strike or lock-out. With respect to the borrower's business, is there a fundamental problem in the market or with the borrower's business plan? Is the borrower diverting funds? Do you need a forensic accountant to determine this? Are the borrower's fiscal problems a result of the overall economic downturn? Does the borrower have other sources of credit? Do you need more information to determine the cause of the borrower's problems?

8. Evaluating rights and remedies. Do defaults under the loan documents actually exist? Did you give appropriate notice with the required opportunity to cure? Is the default material? Is there evidence of a material deterioration in the borrower's financial condition, in the value of collateral or in the prospects for repayment? Did the borrower fail to purchase insurance? Is the borrower only barely out of a financial covenant? Is there a significant lawsuit against the borrower? Is the only default untimely financial statements? Certain of these defaults may not be deemed material. A payment default poses the least risk to a lender.

9. Selecting a strategy. Once the lender determines a default is imminent, the lender has various alternatives, depending upon the terms of the loan document and the law of the applicable jurisdiction. A lender can cease funding, impose a lockbox or a cash flow sweep. A lender can accelerate the debt. If the lender decides to work with the borrower, it can encourage the borrower to address its problems by getting advice from consultants.

While a lender can offer suggested consultants, mandating a consultant or making the borrower's selection subject to a lender's approval will increase the risk of "lender liability" counterclaims. A lender can grant a temporary or permanent waiver of default. It can extend time to cure defaults, generally for a fee. It can apply funds held to the loan balance. A lender can commence a non-judicial UCC Sale and it can exercise judicial rights and remedies, including foreclosures, appointment of a receiver and an action against guarantors. The lender can seek to restructure the terms of the loan, file an involuntary bankruptcy petition or even negotiate a pre-packaged bankruptcy plan.

Steps by a Borrower

1. Evaluating the financial situation. Borrowers need to evaluate the prospects for survival. The most serious error the management of a distressed borrower makes is to avoid facing the reality of its situation and the need for crisis management and a turnaround plan. Is it adequately capitalized? Does it have sufficient cash flow and, if not, can you cut expenses or increase revenue?

2. Being proactive. A borrower should meet with its lender to present a plan. A meeting provides the borrower an opportunity to demonstrate an understanding of its problems and its intention to resolve them. Lenders appreciate borrowers' forthcoming approaches and development of a turnaround plan. Revise the plan as circumstances require.

3. Reviewing loan documentation. Review your loan documentation to determine what action the lender could take if you default. What are the grace periods? Are there personal guaranties? What are the covenants? Have they been breached? Has the borrower correctly reported its financial information to the lender?

4. Evaluating collateral. Is the collateral critical to the operation of the business? If the collateral is not essential, evaluate the possibility of a sale to cover a portion of the debt. The fact that the collateral is worth more than the debt can be either good or bad; good if it gives a lender a degree of comfort to provide time to work with you; or bad if the lender believes it is over secured and chooses to foreclose immediately. How each bank addresses this issue is part of the bank's workout philosophy.

5. Determining leverage. Can the borrower attack the procedures followed by the lender in the perfection of its security interest? Can the borrower allege that it is not in default because of a miscalculation of the debt or misapplication of payments? Can you allege the lack of materiality of a payment default or covenant? Based upon the lender's actions or statements, can you assert that the lender waived the provisions that form the basis of the default or that the parties embarked on a new course of dealing which modified the loan? Finally, can you identify any bad acts by the lender, such as the unreasonable exercise of control over the company, which could support a "lender liability" claim? Such "bad" acts impact on a lender's ultimate decision on whether to work with you or not.

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6. Considering bankruptcy. Can the company reorganize? Consider the value of bankruptcy or the threat of bankruptcy on the business as well as its use as a bargaining chip in negotiating an offer of a restructuring. Depending on the facts, the threat of bankruptcy may be sufficient to achieve a restructuring. However, often it may harden a lender's negotiating position—i.e., "Don't threaten me"—and can call into play "bad boy" guaranties.

Restructuring Agreement

If the lender and borrower agree to a consensual restructuring of the loan, the parties should negotiate a comprehensive agreement which meets the needs of both parties.

Benefits for the lender. The agreement can provide for additional or amended covenants to give the lender better early warning triggers of the borrower's future quarterly, financial reporting requirements for cash flow and financial covenants. Lenders should demand monthly accounts receivable agings, accounts payable and reports of any litigation or material claims. Any restructuring should also allow periodic audits and an examination of the borrower's books and records. Where the borrower has granted a security interest in equipment or inventory, the lender should demand the right to examine the assets and inventory without notice.

A lender should also consider other changes in the loan terms and remedies to improve its position going forward and on default, if possible, obtaining additional collateral or personal guaranties, additional covenants and waivers on lender's actions, as well as changing the forum selection to a more favorable venue.

It should make certain that the borrower reaffirms the debt, waives all defenses, and acknowledges its default, if possible. However a borrower may wish to keep a "no default" provision in place to avoid defaults to other lenders.

Regardless of whether the lender enters into a restructuring agreement, the lender needs to require that the guarantors reaffirm their guarantees.

Benefits to the borrower. From the borrower's point of view, the restructuring agreement should be negotiated so as to provide for terms that the borrower believes it will be able to meet not only in the near term, but with a cushion if its income is less than anticipated in the long term. It should provide for covenants that can be met based upon realistic expectations, not a "best case" scenario.

While not necessarily bargaining from strength, the borrower should try to anticipate adverse changes and build in safety nets on its covenants. If cash flow is tight, the borrower should negotiate a moratorium in payment. If the borrower wants a waiver from the lender of any of its past defaults or consents to any future prohibited actions, such as a sale of the lender's collateral, increase in compensation, distributions or otherwise, such waivers and consents should be built into the agreement.

Ideally the restructuring agreement should serve the needs of both the lender and borrower and provide for both a short-term resolution of the borrower's financial difficulties as well as present a long-term refinancing of the entire debt. If only a short-term solution is contemplated rather than a complete restructuring agreement, a standstill or moratorium agreement may be entered into which is more lender-oriented and seeks only to provide the time to develop a more long-term solution to the borrower's financial problems. In these agreements, the lenders generally will be more concerned with payment terms rather than revisions of many of the covenants and other terms of the Loan Agreement. However, even in these agreements, the lender should obtain the basic provisions of acknowledgement of debt, waiver of defenses and reaffirmation of guarantees.

The bottom line is the time immediately prior to a borrower's default gives both the lender and borrower the opportunity to review and reassess their respective positions, make a realistic determination as to the future performance of the loan and permit them to take appropriate action to avoid a default.

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