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Negotiating the Loan Workouts

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A loan default is a serious event for a borrower, especially when it is caused by financial distress in the borrower's business. Under most loan agreements, a default gives the lender the right to accelerate the loan obligations, take enforcement action against collateral, and charge default interest. In addition, if the default is under a revolving credit facility, a borrower's right to further credit will be cut off unless the lender agrees otherwise. When a defaulting borrower has suffered a downturn in its business, it likely will need to approach its lender to request a workout plan. Such plans typically involve waiver of the existing defaults and restructuring of the loan terms and covenants. But dealing with lenders on a loan workout can be daunting, especially for borrowers who have not faced this situation before. This article provides an overview of items to consider when approaching lenders and negotiating a workout, as well as an explanation of the legal documents that a borrower is likely to encounter.

1. Approach lender early, be honest and ensure financial statements are in order. Many borrowers are reluctant to notify their lenders of potential problems *before* a default occurs. They wait until their financial statements reveal a default under their financial covenants or some other default has occurred. Those borrowers may be embarrassed by their financial distress or may be hoping that their problems will be rectified before an actual default. What those borrowers fail to understand is that this is precisely the time when the lender needs to be reassured that the borrower's management is forthright, honest and competent. Advance notice to the lender and an honest assessment of the situation by the borrower's management are the keys to developing the trust necessary for a workout plan to succeed from the borrower's perspective. In addition, the lender must have complete confidence in the borrower's financial reporting - if there have been any reporting issues in the past, the borrower must quickly resolve them. Unless the lender trusts the borrower's management and its financial statements, it may pursue remedies far less appealing than a loan workout.

2. Read your loan documents - all of them - and comply. Reading the operative documents is always good advice for working through any legal issue. But it is especially important to read loan documents after a default. Borrowers with many different financing arrangements, such as real estate developers, should determine whether a default under one

loan agreement triggers a default under its other loan documents. In addition, even for a borrower with only one financing in place, many things that the borrower routinely did before the default - such as disposing of assets outside the ordinary course of business, making certain investments, or making distributions- may be prohibited by the loan documents while a default exists. Taking any action that is restricted by the loan documents after a default could undermine the lender's confidence in the borrower and its management. The lender wants to know that its borrower takes seriously the gravity of the situation and is mindful of honoring the agreed-upon covenants and not causing new defaults. The borrower should realize that the decision maker for the lender may no longer be the same credit personnel with whom it has been dealing for the last several years. Instead, someone in the lender's special assets area may be the decision maker and may view the borrower's position and the lender's agenda differently.

3. <u>Terms of workout plans vary widely</u>. The terms of a loan workout will differ greatly depending on the circumstances of the particular situation. Unlike loan documents that are negotiated at the start of a lending relationship, there are few "market standards" for workout terms. Remember, a lender has no obligation to waive existing defaults and restructure the borrower's loan documents. On the contrary, the lender is free to exercise the rights and remedies that it negotiated for in the loan documents. However, a lender's motivation is maximizing its recovery, and the best way to do that is often for the borrower's business to continue in one way or another. In some situations, all that may be required is a loosening of the financial covenants and an increase in interest rates. Other times, the lender may request that additional capital (equity or junior debt) be invested in the borrower or that the borrower dispose of a particular subsidiary or division, with the proceeds used to reduce debt. All of these items (as well as many other possibilities) will be the subject of negotiation. From the borrower's perspective, the critical elements of the loan workout are that all existing defaults are waived, that it has sufficient working capital (or access to sufficient revolving credit) to meet its required expenditures (including future debt service), and that the financial covenants have been restructured to levels that it can live with for the foreseeable future.

4. <u>Consider tax issues</u>. Borrowers should carefully consider the tax implications of any modification to the loan terms in a workout. As a general rule, if there is a reduction or cancellation of all or a portion of the loan, then the borrower will incur taxable income in the amount of the reduction. In addition, for borrowers with debt that is regularly traded or for which price quotations are regularly available (which is the case for many borrowers with syndicated term loans), the tax consequences can be worse. For that type of loan, certain modifications to the deal terms can result in taxable income to the borrower even if the principal amount of the loan is not reduced. Under the tax code, if there is a significant modification of a loan (which could include an increase in interest rate, a payment of fees in connection with a waiver of default or an extension of the debt's term beyond certain safe harbors), the modification is treated as an exchange of the "existing loan" for a "new loan." When the loan is regularly traded or has price quotations that are regularly available, the tax code deems the price at which the new loan is issued (and the price at which the existing loan is repaid) to be the price at which the loan is trading or quoted at the time of the amendment. Thus, if a syndicated term loan trades at a price less than the face amount of the outstanding principal, the borrower recognizes taxable income at the time of the modification based on the difference between the face amount of the loan and its trading value. For example, if the borrower's term debt is trading at 62% of its actual principal amount - which, according to *Standard & Poor's Leveraged Data and Commentary*, was the average bid price for all regularly traded syndicated term debt as of December 31, 2008 - the tax code would treat the amendment as having resulted in (1) an issuance of a new loan at an issue price equal to 62% of the principal amount of the existing loan, (2) a repayment of the existing loan with the proceeds of the new loan (again, at 62% of the principal amount), and (3) taxable income to the borrower equal to 38% of the existing loan's principal amount. This treatment of the deemed exchange of loans could also result in tax issues under the tax code's high-yield OID rules.

5. Legal documents used in workouts. From the identification of the loan default to the implementation of the workout plan, a borrower can expect to encounter some or all of the following legal documents:

- Notice of Default. Most loan documents do not require that the lender provide notice of default to the borrower in order for the borrower to be in default. On the contrary, most loan documents require that the borrower provide notice of each default to the lender. Nonetheless, it is very common for a lender to provide written Notice of Default to the borrower to create a written record of the existence of the default. A Notice of Default may or may not be coupled with the Reservation of Rights Letter described below.

- Reservation of Rights Letter/Negotiation Protocol Agreement. Because of the scrutiny that courts and regulatory agencies have given lenders in their dealings with borrowers, it is common for lenders to send a Reservation of Rights Letter after the occurrence of a default. This letter acknowledges the existence of a default and states that the lender is evaluating its response and that its failure to take action immediately does not waive any remedies available to it. Some lenders prefer that the borrower and lender execute a Negotiation Protocol Agreement, under which the lender and the borrower will agree (1) that a default exists, (2) that the two parties are entering into negotiations concerning changes to the loan documents to address the default, and (3) that either party, particularly the lender, can terminate negotiations at any time and exercise any rights and remedies available to it. Both the Reservation of Rights Letter and Negotiation Protocol Agreement are more about the process of discussion and negotiation between the borrower and lender than the exercise of remedies by the lender or the restructuring of the loan terms.

- Forbearance Agreement. With a Forbearance Agreement, a lender typically does not agree to waive the existing defaults but simply agrees to forbear from exercising certain rights and remedies under the loan documents (i.e. acceleration, action against collateral, the accrual of default interest, etc.) until the earlier of a date certain or the occurrence of a new default. It is important to note that a Forbearance Agreement does not waive the existing default, which continues in existence. It is also important to note that upon the occurrence of a default other than those specified in the Forbearance Agreement, the lender's agreement to forbear automatically terminates. Often, a Forbearance Agreement is executed to define the rights of the lender and borrower during a limited period while a more extensive waiver or amendment is negotiated and documented.

  The actual language of the Forbearance Agreement is key to outlining the rights of the borrower during the period of forbearance. Things that may be addressed include the borrower's right (1) to borrow under a revolving credit facility, (2) to continue LIBOR borrowings or tranches upon expiration of existing interest periods, and (3) to take other action that would otherwise be restricted by the loan documents during a default, such as disposing of assets outside the ordinary course of business, making certain investments, or making tax distributions to equity holders of an S-corporation or limited liability company. Because the existing defaults are not actually waived in a Forbearance Agreement, a borrower should examine its loan documents carefully to ensure that they permit it to take necessary actions during the period of forbearance. This is even more important when dealing with a group of lenders, rather than one. It may be much more difficult to seek approval from a lender group to take certain prohibited actions after the Forbearance Agreement is signed. Of course, any request for temporary covenant relief by the borrower in the Forbearance Agreement can be resisted by the lender and ultimately become subject to negotiation.

• Waiver. After the lender executes a Waiver, the defaults specified in the Waiver no longer exist for purposes of the loan documents, meaning that the lender has no further rights to exercise remedies on account of such defaults. An amendment to the loan documents may or may not be executed in connection with a Waiver. Note that most Waivers will be very clear that the lender is only waiving its rights with respect to those defaults specifically described in the Waiver. Also, be aware that in syndicated credit agreements, most defaults can typically be waived by some agreed-upon percentage of the lenders, but the waiver of certain defaults (including payment defaults) likely will require the agreement of all affected lenders. In addition, the waiver of a default for purposes of permitting future draws on a revolving credit facility may require the consent of an agreed-upon portion of the revolving lenders.

• Amendment. An Amendment is exactly what it sounds like - an amendment to the terms of the loan documents. As with a Waiver, most amendments to a syndicated credit agreement can usually be made by some agreed-upon percentage of the lenders, but certain amendments (such as a reduction in future amortization payments or cash interest) will require the consent of all affected lenders.

Finally, note that with any document executed by both borrower and lender in which the lender is making a concession to the borrower with respect to the loan terms (such as agreeing to forbear, waiving a default, agreeing to an amendment in favor of the borrower), the lender is likely to require that the document include a release by the borrower of all claims against the lender for any actions occurring prior to the document's execution.