Dealing With a Troubled Loan In Today's Environment:

Strategies and Tactics For the Traditional Lender

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Lending is increasingly a different business. The presence of hedge funds and other specialized lenders in what was once the exclusive domain of traditional banks has increased competition on the front end and, on the back end, has given the traditional bank an exit strategy from a troubled loan that previously did not exist. The presence of these new players, along with changes in the Bankruptcy Code, has caused workouts and restructurings to become much more complex. It is increasingly common for a "lender" to provide capital into a company with the trappings of an equity infusion. Indeed, the primary motive of the lender may have nothing to do with earning its living as a lender, but rather in employing a "loan-to-own" strategy.

Thoughts shared here are intended for the more traditional lender, who, from time to time will be faced with the difficult situation of having to deal with a troubled loan. When this happens, what do you do? Whom do you call? What do you say? How do you recover the principal loan balance, or at least as much of it as you can?

Strategy must be quickly developed and executed to minimize any ongoing diminution of collateral and to maximize the recovery on the loan. Yet, at the same time, actions taken should not be inappropriately detrimental to the borrower's other stakeholders. If for no other reason than the lender is often viewed as a "deep pocket" by other creditors, who sometimes will recover little to nothing on the debts owed by the company unless they expand their targets of potential recovery to include the lender. Any business strategy should be approached with an informed understanding of the overall legal landscape from all parties' perspective to understand their drivers and to plan accordingly.

Problem loans

A loan, sometimes referred to as a "credit" in the loan portfolio, is given a coding referred to as "credit status." The terms may vary at each institution, but many contain terminology equivalent with "good," "watch" and "work-out". In some instances, the loan has been in "watch" status shortly after the bank made the loan. This is common with specialty lending areas at banks, typically labeled as "business credit," "bank name capital" or niche focus such as "retail finance" for borrowers that may be shutting down facilities while under Chapter 11 protection. With compe-

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tition in the marketplace accelerated, many traditional lenders are expanding their portfolios to include such transactions.

Bank lenders generally deal with troubled loans in their portfolio in one of two ways: the loan may be moved into a troubled loan department or the designated party at the bank, who has been the loan portfolio manager, may continue to handle activity with the borrower even after an internal change is noted in the "credit status" with the bank.

In either situation, the steps taken with a troubled loan are fairly similar. In many cases, the loan is not rotated to troubled loan status quickly enough. A loan can stay in watch status for many months, but, unless attention is brought to the ongoing issues, it may not be visible enough to those at the lending institution charged with solutions. For a loan that is not in watch status at inception, a loan covenant default changes its status in the loan portfolio and draws attention and appropriate actions by the lender. A loan covenant is commonly "tripped" due to financial statement results, amounts of borrowings or based on preliminary sales results.

For these types of defaults, the lender may be willing to draft multiple forbearance agreements with the company, allowing for the covenant defaults. It is at this point that outside advisors often first arrive to the scene. Upon default and forbearance, lenders can, and usually do, require that a company retain the services of a financial and management consultant to advise on the viability of the company and/or offer the lender a general perspective on the company. Lenders typically have past experience with a number of such firms and will prefer that one of those firms be retained.

To limit potential lender liability, the lender should recommend several firms for the company to consider retaining. It is worth noting that the financial advisor may take a management role at the company at the owner/board's request to empower them to cut through internal corporate red tape and identify and implement solutions to troubled situations. It is also at this time that the borrower typically engages legal counsel if it has not already done so.

The forbearance is usually in the form of an amendment to the loan agreement and allows the lender to redefine the loan covenants. However, if default by the borrower is not on loan covenants but due to violation of the agreement, such as failure to audit books and records or inappropriate use of collateralized assets, the lender may choose not to grant forbearance. Absent such wrongdoing, providing the company multiple forbearance opportunities may prove helpful in forestalling possible litigation.

Eventually, based on business performance, a decision needs to be made by the lender as to whether to continue lending to a company. At the same time, the company management may be considering whether to continue operations. In some instances, the proper business strategy may be to try to save the company. Broken balance sheets can be fixed if there is sufficient consensus among the parties at the various levels of the company's capital structure. Flawed business models can, in many instances, be improved. To avoid lender liability, the lender should refrain from making comments on the viability of the company or as to whether it should reorganize or liquidate. Those decisions must be left to company management and recommendations left to the financial advisor and should not reflect the influence of the lender.

A troubled company may need cash infusions to continue operating for a period of time until the decision of reorganization versus wind-down is made. Although as the current lender, you may prefer that the company obtain a new lender, it is possible that no other lender is willing to step into the situation. The current lender may find that it will need to maintain its funding in order to preserve the collateral and maximize recoveries to itself and other creditors. Actions that are contrary may even lead to litigation risk.

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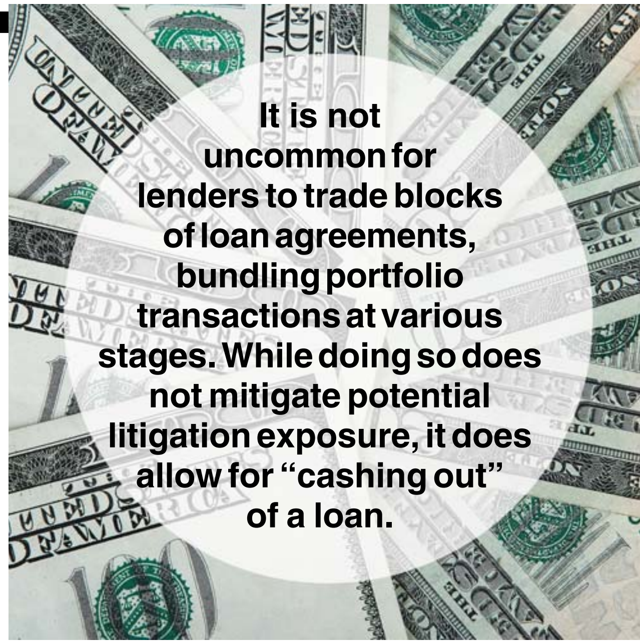
The lender's alternative

Selling the loan: Typically, lender agreements allow for the transfer of a loan from one institution to another. It is not uncommon for lenders to trade blocks of loan agreements, bundling portfolio transactions at various stages. While doing so does not mitigate potential litigation exposure, it does allow for "cashing out" of a loan.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Force a quick sale or work with the debtor on a longer sale process: Using consistent covenant defaults as a basis, a lender may request that the financial consultants prepare a report recommending a next course of action. If there is a question about viability of the business, the lender may choose to accelerate the loan as payable in full by a certain date. If the company is unable to find a new lender by the deadline, the company may find itself liquidating the lender's collateral (company assets) to pay the loan. Loan agreements typically grant the lender empowerment in the decision process of liquidation. However, the company can table such demands through the automatic stay provisions in a Chapter 11 filing, though the company is not limited to using Chapter 11 as a vehicle of protection. The lender should be aware of the multitude of solutions available to the company. Included below are several such solutions including state law dissolution, assignment for the benefit of creditors, receiverships and bankruptcy protection under Chapter 7 and Chapter 11.

In many cases, a straight dissolution is a simple, quick and inexpensive method for an insolvent company to pay its creditors as much as possible. However, it is not the preferred method where a going-concern sale is feasible or where there may be significant bankruptcy causes of action to pursue for the benefit of the operating stakeholders. Also, this out-of-court option runs the constant risk that the company's creditors may file an involuntary bankruptcy petition against it, which can be quite damaging. If the court determines that the company belongs in bankruptcy, there is a presumption that the proceedings will be held in the court where the involuntary petition was filed. This deprives the company of the various legal and practical advantages that it might otherwise have obtained if it had the opportunity to choose its own venue for filing.

With respect to the distribution of assets, state law usually provides that, upon the winding down of the company, the assets shall be distributed as follows:

- To the subsidiary's creditors in satisfaction of the subsidiary's liabilities (secured lenders are paid the collected proceeds for the sale of said assets);
- To the establishment of a reserve which the liquidating trustee may deem necessary for contingent or unforeseen liabilities; and
- Thereafter, to the shareholders.

In cases where there are insufficient assets to pay all creditors' claims in full, claims will be paid according to their priority and ratability to the extent assets are available (much like in bankruptcy). A composition agreement, whereby creditors agree to accept a certain distribution in full satisfaction of their outstanding claims, may be employed in conjunction with a dissolution or standalone. A composition agreement can also contain a provision prohibiting individuals from commencing an involuntary bankruptcy proceeding against the company. Viewed most simply, a composition agreement is simply a contract between the debtor and a single creditor. Debtors will sometimes send composition agreements to each of their creditors that include, as a precondition to the company's obligation hereunder, that a certain preset percentage of the debtor's creditors and claims accept the composition in order for such agreement to be binding (in a manner similar to an exchange offer). The lender may find itself in a position where it is in their best interest to fund the composition settlement to avoid potential litigation exposure.

Another popular dissolution alternative is an assignment for the benefit of creditors. A vast majority of states provide for this alternative to a federal bankruptcy filing, either by statute, common law or both. An assignment for the benefit of creditors is a voluntary insolvency process in which the insolvent company (aka, the "debtor" or "assignor") assigns all its property to a designated assignee for liquidation. The assignee then liquidates the property and distributes the assets to the company's creditors in accordance with certain procedures and priorities.

The process varies from state to state. Less favorable schemes treat the process much like a probate estate. Other states offer a more streamlined process. In addition, certain states do not require that the assignee be local or domiciled within the state. Upon liquidation, claims are paid in

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One additional advantage of an assignment over a straight dissolution is that, although creditors may still file an involuntary bankruptcy petition against the debtor, a bankruptcy court is more likely to abstain from exercising jurisdiction where there is a pre-existing assignment for the benefit of creditors in process.

substantially the same priority as such would be paid pursuant to the applicable provisions of the U.S. Bankruptcy Code. Instead of the Bankruptcy Code however, the priority scheme is usually enumerated by state law and/or in a composition agreement formulated by the assignor and assignee, subject to certain specific statutory mandates with respect to the priority of claims. Similar to a trustee in bankruptcy, an assignee has standing to prosecute and defend claims on behalf of and against the debtor/assignor. Included among these claims are state law versions of preference and fraudulent transfer avoidance actions.

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Another course is the receivership, which has been around since at least the 19th century. In receivership, a company's assets are placed under the control of a receiver, which is a court-designated party, so that value can be preserved for the benefit of creditors. Not surprisingly, changes in the Bankruptcy Code in 2005 have turned the focus back on state receiverships as an alternative to the costly expense of a Chapter 11 filing. However, depending on the situation, the receivership does not offer the same benefits as a Chapter 11 filing. For example, in Chapter 11 a debtor can reject contracts which it cannot under state law, due to the Contracts Clause of the Constitution. Nor can a company cure and assume certain contracts while in state receivership. Also, a major difference from a Chapter 11 filing is that the state's jurisdiction ends at the state's borders. For business units in other states, additional receiverships must be set up where the debtor has assets. Under Chapter 11, the bankruptcy court has nationwide jurisdiction.

Chapter 7 of the Bankruptcy Code provides a formal procedure for the orderly liquidation of the company's assets and the ultimate payment of creditors' claims in the order of priority set forth in the Bankruptcy Code. Upon the filing of a Chapter 7 petition, a trustee is appointed by the United States Trustee and charged with marshalling all of the company's assets, liquidating the estate and eventually distributing the proceeds of the liquidation to its creditors.

Unlike a straight dissolution or assignment for the benefit of creditors, neither the equity holder nor the subsidiary has the ability to choose the person or firm who will serve as the trustee in a Chapter 7 bankruptcy. Moreover, Chapter 7 proceedings are presided over by a federal bankruptcy judge and are governed by a detailed and often cumbersome federal statute and series of complex rules. Together, these factors result in a total loss of control over the liquidation process.

Therefore, to the extent there is concern that the company's and other parties' (including lenders) prebankruptcy actions may be challenged, Chapter 7 may not be preferable as it will empower and fund a trustee, who is likely to bring such challenges. However, Chapter 7 does provide perhaps the clearest means by which the company's management can effectively wash its hands of any future management obligations to the subsidiary and its wind-down process. Indeed, among other things, the federal Bankruptcy Code provides a uniform, multistate level of statutory authority and jurisdiction over assets. Assignment laws are much less clear and uniform. In addition, the relevant insolvency professionals, including the presiding judge, are more apt to be experienced with the workings of the various tenets of the Bankruptcy Code as such pertain to an insolvent subsidiary's particular circumstances.

A key benefit of Chapter 11 over Chapter 7 and the other alternatives discussed above is that Chapter 11 permits the company (aka, the "debtor in possession" or "DIP") to remain in control of the process. Throughout the Chapter 11 process, however, the DIP's decisions remain subject to bankruptcy court approval and review by the Office of the United States Trustee and committee (if any). Chapter 11 is a complex and expensive wind-down alternative. However, its advantages include providing a method by which a purchaser can receive perhaps the cleanest title in the transferred assets.

While the DIP is busy assessing its liabilities and formulating and confirming its Chapter 11 plan, it enjoys the benefit of the automatic stay of the Bankruptcy Code. The automatic stay effectively prohibits the creditors from engaging in any type of collection activity against the estate, other than filing a proof of claim, during the pending bankruptcy case. The automatic stay is one of the primary

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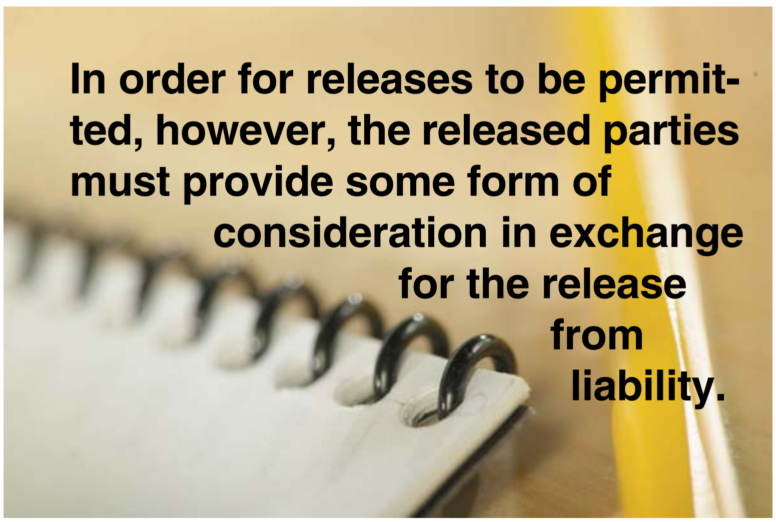
benefits of bankruptcy as it is intended to give the DIP breathing space in which it can focus on its Chapter 11 plan without the pressures associated with creditors' collection activity. Unfortunately, it may then become a constant battle for the lender who is burdened with proving to the court that continued use of collateral (liened assets) is diminishing their value and therefore the estate.

Additionally, the Chapter 11 process provides for protection for postbankruptcy financing, whereby the lender (which is, in some cases, the equity holder) can obtain a bankruptcy court order approving the terms of the postbankruptcy financing agreement (aka, DIP loan). By obtaining this approval, the lender obtains full assurance that its loan will not be recharacterized or otherwise subordinated to the DIP's other creditors.



Another potential benefit of Chapter 11 is the ability, in certain jurisdictions, to obtain broad releases from the subsidiary and its creditors for the parent and/or its directors and officers. These releases can be incorporated as part of the Chapter 11 plan. In order for releases to be permitted, however, the released parties must provide some form of consideration in exchange for the release from liability. For directors and officers it is possible that, depending upon the jurisdiction, the consideration requirement may be met through their continued service to the subsidiary during the pending bankruptcy case. The parent, however, would likely need to concede some or all of its claims against the subsidiary or propose some other means by which it can offer the subsidiary additional value in exchange for a release.

Conversely, there may be greater value to marketing the business in order to receive more value for its sale (as a going concern versus asset liquidation, for example). In that case, the lender may agree to provide a period of time to research such solutions and to execute them.

Support a full reorganization: The Company may be contemplating a full reorganization and revitalization of its business or may be utilizing the vehicle of Chapter 11 for disposal of non-core subsidiaries/assets, lease assignments or other purposes. The lender may be in approval of these plans and continue to work with the company. The lender may do so in a variety of ways, most common of which is to become a DIP lender and continue lending to the company while it continues operations in Chapter 11.

Bankruptcy risks

While bankruptcy provides many benefits to a debtor — and consequently to a debtors creditor's — bankruptcy also provides an open and ready forum for litigation. Moreover, certain causes of action, such as equitable subordination and recharacterization, are unique to bankruptcy, and could not otherwise be brought in the context of an alternative insolvency proceeding, such as an out-of-court dissolution or assignment.

A bankruptcy case can encourage inquiry into, and prosecution of, such potential litigation. At the outset of the case, a formal creditors' committee (in a Chapter 11) or Chapter 7 trustee is appointed and specifically charged with examining the company's prebankruptcy transactions, including its relationship with its parent. The committee's (or trustee's) primary goal is to obtain, through whatever appropriate means available, the greatest return for their constituents — the subsidiary's creditors — of which the parent is likely but one of many. To that end, the creditors' committee (or trustee, an independent fiduciary with no loyalties to management) will use the bankruptcy causes of action to attempt to obtain more funds to distribute to the subsidiary's creditors.

The fees and costs associated with these activities are typically funded out of the debtor's assets. As a result, there is considerably less inhibition to their prosecutorial efforts, compared to that which would otherwise exist if each creditor was required to pay its own legal expenses as they would be outside of bankruptcy. Such diminution of asset values is to the detriment of all stakeholders.

Typical insolvency-related causes of action include, but are not limited to:

Fraudulent transfer action: This cause of action exists both in and out of bankruptcy and takes two separate forms — Actual Fraud and Constructive Fraud. When either actual or constructive fraud is established, the plaintiff can unwind the transfer and claw back the property for the benefit of the company's creditors.

CONSTRUCTIVE FRAUD REQUIRES NO ACTUAL INTENT TO DEFRAUD, BUT ONLY A SHOWING THAT THE COMPANY, WHILE INSOLVENT, MADE A TRANSFER OF CASH OR ASSETS WITHOUT RECEIVING REASONABLY EQUIVALENT VALUE IN EXCHANGE.

Actual Fraud requires proof of intent by the transferor to defraud some of its creditors. Intent can be established by showing that the company displayed certain indicia, or "badges," of fraud in connection with the transfer in question. These include, for example, absconding after the transfer, concealing assets and/or the transfer, or making the transfer shortly after being threatened with a large lawsuit.

Constructive Fraud requires no actual intent to defraud, but only a showing that the company, while insolvent, made a transfer of cash or assets without receiving reasonably equivalent value in exchange.

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Preference action: Preference actions are primarily seen within the context of bankruptcy cases, although some states' assignment for the benefit of creditors' statutes provide for similar causes of action. Essentially, once a company files for bankruptcy, under certain circumstances, payments to creditors made within the 90 days prior to the bankruptcy filing date can be clawed back for the benefit of all of the estate's creditors. For insiders, such as a parent, the applicable look-back period is extended to a full year.

Equitable subordination: Under the doctrine of equitable subordination, a creditor's claim can be subordinated to claims of other creditors where the court finds that: i) the claimant engaged in some type of inequitable conduct; and ii) the conduct resulted in injury to the debtor's creditors or conferred an unfair advantage to the claimant.

Where equitable subordination is warranted, courts generally limit the subordination to the extent necessary to remedy the particular harms at issue, sometimes subordinating less than all of the holder's claim or subordinating the claims to only a particular category of the remaining creditor group.

Recharacterization: As discussed earlier, a bankruptcy court can recharacterize prebankruptcy loans, especially those of a parent and or private equity group that may also be holding stock/warrants. If recharacterized, the loan will be treated as just another equity investment in its subsidiary. Recharacterization may effectively cause a similar result to that of equitable subordination, but without the need for the plaintiff to show inequitable conduct. In addition, if a court recharacterizes, it will recharacterize the entire amount of the purported loan. Moreover, a compound threat may also arise upon recharacterization of

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the loan, in that any prior repayments may be recoverable as fraudulent transfers, assuming the subsidiary was insolvent when it made such payments.

Deepening insolvency: One additional cause of action that could be brought against an insolvent company's parent and/or directors and officers is known as "deepening insolvency." Recognition and use of deepening insolvency as a separate and distinct tort claim is relatively new and still developing. The trend, however, is to provide injured

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creditors with an avenue of redress against solvent third parties whose control and decision-making contributed to the continued downward spiral of the company.

Deepening insolvency is founded in the theory that those in control of the insolvent company should be liable to those harmed, where the life of the business was fraudulently or negligently extended, and that resulted in a continued worsening of the business to the detriment of the company's creditors. The increasing popularity of this cause of action should breed caution when employing costly out-of-court turnaround strategies. In some circumstances, it weighs in favor of filing for bankruptcy protection early to avoid risking liability for any failed attempts to salvage the distressed business. Lenders are not exempt from this type of litigation exposure and should scrutinize strategies accordingly.

Conclusion

When confronted with an underperforming or insolvent company, it is important to initially identify the most critical objectives and expectations. In some cases, an analysis of these objectives may result in a determination that the company, though struggling, is worth saving. In other cases, the directors and officers or private equity fund may want nothing more than to wash their hands of the company and limit any additional liability that may arise as a result of the company's insolvency.

In the latter scenario, it is important to remember that there are a number of procedural alternatives, and combinations of alternatives, that can be used to wind-down the insolvent company. When making the selection, it is important to consider the range of liabilities that may remain or arise in the context of any insolvency, and which procedural vehicle can best limit such liabilities.

Although an insolvent company's creditors are entitled to the company's—and its directors and officers'—fiduciary obligations, directors and officers can, under certain circumstances, still meet their fiduciary obligations to such creditors yet, also take steps to maximize recovery for the principal equity holder as well. The equity holder, however, may decide to hedge its position by installing an independent board of directors who are charged with making those decisions that could detrimentally affect the interests of the company's creditors. Nonetheless, in any case, it is important for the equity holder to remain cognizant of the various liabilities that may arise on the frontier of insolvency and consider such risks when determining when and how to dispose of its insolvent subsidiary. ▲