Chapter Two

# Dealing with Secured Lenders[1]

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With investors continuing to pursue higher yields, the market for secured debt has experienced a resurgence since the depth of the financial crisis of 2008. For borrowers, the lenders' willingness to make these loans has translated to increased liquidity and access to capital for numerous purposes, including (i) providing working capital and funding for general corporate purposes; (ii) funding an acquisition-related transaction or a recapitalization of a company's balance sheet; or (iii) refinancing a borrower's existing debt. The increased debt loads may lead to financial distress when a borrower's business sags, at which point management will typically turn to its secured lenders to begin negotiations on the restructuring of the business's debt. Consequently, the secured lenders usually take the most active role in monitoring the credit and responding to problems when they first arise.

Secured loans come in many different forms and are offered from a range of different investors. The common feature for secured debt is the existence of a lien on all or a portion of the borrower's assets. Following is a brief overview of the common types of secured lending:

> *Asset-Based Loans.* The traditional loan market consisted of an asset based lender (traditionally a bank or commercial financing institution) providing revolving loans, term loans, and letters of credit secured by a first priority lien on accounts receivable, inventory, equipment, and

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other business assets.[5] These loans can be made in large, syndicated transactions as well as in single-lender and "club" deals. Recently, non-traditional investors (hedge funds and other distressed investors) have become significant originators of asset based loans to middle market borrowers and secondary market buyers of asset based loans to all types of borrowers.

*Second Lien Loans.* Over the course of the last five years there also has been a proliferation of second lien lending transactions.[6] In a second lien loan transaction, a second lien lender will provide a term loan secured by a second priority lien on substantially all of a borrower's assets. The second lien lenders' security interest ranks junior to the liens in those assets securing the first priority lien debt (usually the revolving loan asset based lender). The rights of the first lien lenders relative to the junior lien lenders will usually be memorialized in an intercreditor agreement. The typical intercreditor agreement contains provisions that restrict second lien lenders from taking certain actions with respect to the common collateral. As one court put it, "the purpose and function of an intercreditor agreement between the first lien parties and second lien parties [is to put the] first lien lenders . . . 'in the driver's seat' when it [comes] to decisions regarding collateral."[7] As such, an intercreditor agreement may restrain second lien lenders from taking enforcement actions (such as foreclosing on collateral), receiving payments from the borrower, or from exercising remedies with respect to the common collateral for a specified "standstill" period. The standstill arrangement

5. In some instances, where a borrower has multiple debt facilities, an asset based loan may be secured by a first priority interest on certain assets (e.g., "current assets") and a second lien on other assets of the borrower which are subject to a first priority lien in favor of another creditor (e.g., a term loan lender).

6. Approximately $38.7 billion of second lien loans were issued in 2014, representing a nearly sixfold increase from $6.8 billion of second lien loans issued in 2011 and almost matching the record $39.2 billion issued in 2007. *See U.S. Second Lien Loan Issuance to Slow in 2015 Despite Expected E&P Interest*, Business Wire (Feb. 2, 2015, 2:24 PM), http://www.businesswire.com/news/home/20150202006169/en/U.S.-Lien-Loan-Issuance-Slow-2015-Expected#.VgrJ_flVhBc (last visited Sept. 29, 2015); Steven Messina, *Encouraging Signs for Leveraged Loans in 2013*, Law360 (Jan. 28, 2013, 5:30 PM), http://www.law360.com/articles/410782/encouraging-signs-for-leveraged-loans-in-2013 (last visited Sept. 29, 2015).

7. *In re* Boston Generating, LLC, 440 B.R. 302, 318 (Bankr. S.D.N.Y. 2010). *See also In re* MPM Silicones, LLC, 518 B.R. 740, 750 (Bankr. S.D.N.Y. 2014) ("The focus . . . of an intercreditor agreement between two groups of secured lenders . . . is on their rights and remedies in respect of the shared collateral.").

buys time for the first lien lenders to negotiate with the borrower while avoiding a potentially negative impact on the borrower's financial position that may result from actions taken by the second lien lenders. An intercreditor agreement also may limit second lien lenders from taking certain actions in a borrower's bankruptcy case without the first lien lenders' consent, including challenges to approval of a DIP loan or objections to sales of common collateral.

*Unitranche Loans*. A relatively new product—a so-called unitranche loan—has emerged in the middle market lending sector as an alternative to the traditional first and second lien loan structure. The unitranche facility involves "B" loans and other "last-out" debt financings, which refer to loans that share the same lien securing the "A," or senior loans, but the proceeds of collateral subject to such lien are applied first to repay the "A," or "first-out," loans and second to repay the "B," or "last-out," loans. Unitranche facilities combine two layers of secured debt into a single credit agreement that is administered by a single agent for the secured lenders, with the borrower paying a single "blended" interest rate to all lenders. Typically, the borrower grants to the agent one lien securing all obligations under the facility. Borrowers and secured lenders find unitranche facilities attractive due to the reduced time needed to close, lower syndication risk, and lower administrative costs and burdens. The intercreditor relationship between the A and B lenders can be memorialized in the main credit agreement or, as is more typical, in a separate agreement among lenders (AAL). An AAL defines which secured lenders are senior and which are subordinated (referred to as first-out lenders and last-out lenders, respectively) and establishes a payment waterfall providing for payment (or application of the proceeds of collateral) to the first-out lenders prior to payment to the last-out lenders. An AAL will typically include provisions that also govern lenders' respective rights in bankruptcy and exercise of remedies. One of the advantages of a unitranche facility is the significant cost savings associated with negotiating a single credit agreement. On the other hand, because a unitranche structure contemplates that a larger amount of debt is secured by a single lien, there is a greater chance that the entire debt position is not oversecured and, therefore, not entitled to postpetition interest in a bankruptcy scenario.

When a borrower has financings involving multiple tranches or more than one facility, secured lenders will have different priorities with respect to collateral and different enforcement rights. One of the challenges of navigating through a successful reorganization is balancing these potentially divergent interests with the need to develop a coordinated and efficient approach to a borrower and its problems.

## ADMINISTRATION AND MANAGEMENT OF THE SECURED LENDERS AND GOVERNING THE RELATIONSHIP AMONG SECURED LENDERS

In multilender facilities (i.e., asset based loan, second lien loan, unitranche facility), the responsibility for the administration and management of the lending group belongs to the lender designated as the "agent" under the loan documents or to a designated agent that might not hold any of the underlying debt. The loan agreement contains agency provisions governing the relationship between the lenders and the agent. The administrative agent (or a separately designated collateral agent) typically holds the lien on all the collateral securing the loan for the pro rata benefit of all lenders. The agent relays all formal communications from the group to the borrower as well as certain information that it receives from the borrower, and, at least initially, plays the leading role in workout negotiations. The agent also monitors the financial position of the borrower by reviewing the borrower's compliance with the financial covenants in the loan documents and through regular communications with the borrower.

## THE SECURED LENDERS' PERSPECTIVE

### Legal Document Review

At the outset of a workout, the secured lender should conduct a thorough legal review of the borrower's debt instruments, major contracts, and collateral, including any intercreditor agreements or "agreements among lenders." Through this review, particular risks can be identified and evaluated. The number, types, and degrees of these risks will play a significant part in the ultimate resolution of the workout because they will influence the types of concessions the secured lenders may be asked, and would be willing, to give. In addition, to the extent there are defects in the documentation or in the priority or perfection of liens, whether intentionally or inadvertently, these matters can be dealt with early in the process while the borrower and the secured lenders may be on more cooperative terms. However, secured lenders should recognize the possibility that certain transfers, including securing previously unsecured debt or taking new collateral, run the risk of being preferences that are avoidable should a bankruptcy case or insolvency proceeding ensue shortly thereafter.[8]

*Credit Agreement Review*

A first step in the review process is an analysis of the loan documents for the purpose of determining the secured lenders' rights against the borrower and its collateral as well as the nature and extent of the secured lenders' obligation to continue funding loans during the pendency of the restructuring process. The document review also should focus on the loan covenants to determine whether the borrower has discretion in areas in which the secured lenders may want to involve themselves, such as asset sales, the incurrence of additional indebtedness, or granting additional liens. In addition, the analysis should include an examination of the various events of defaults set forth in the loan documents, as well the potential grace and cure periods relating to such defaults.

*Collateral and Perfection Review*

A review of the security documents should address the nature and extent of the secured lenders' collateral, with a view to determining whether there are covenants requiring the borrower to grant additional security and to confirming that the secured lenders' liens on the existing collateral have been correctly obtained and perfected and whether those security interests have the intended priorities. When performing a perfection analysis, secured lenders' counsel should carefully review those asset classes where special perfection requirements beyond merely filing a financing statement may apply. For example, secured lenders must have "control" of cash (typically through a deposit account control agreement with a borrower's bank) in order to become properly perfected in such cash. Secured lenders also may need to file financing statements with regulatory authorities in order to properly perfect security interests in asset classes such as rolling stock, aircraft, and certain types of intellectual property. Additionally, secured lenders seeking a lien on commercial tort claims must specify the actions that will be subject to the lien—it is not sufficient to include a general description of the borrower's pending tort actions. It is important for secured lenders to identify any collateral gaps early in the workout process because these findings will influence the secured lenders' restructuring strategy. Indeed, to the extent that the perfection review reveals gaps in the collateral package, the secured lenders should consider providing a debtor-in-possession ("DIP") financing loan in the event the borrower commences a bankruptcy case. As discussed in Chapter 10, "offering postpetition financing allows prepetition lenders to avoid losing control

8. For a discussion of avoidable preferences under the Bankruptcy Code, *see* Chapter 11.

to postpetition lenders and to obtain the postpetition lending business (and related fees) as well as an order of the court that may validate the lenders' prepetition liens." In addition to the perfection analysis, counsel should perform "bring down" lien searches to determine if any financing statements, tax liens, or judgment liens have been filed since the loan closed. This analysis is important because certain types of liens (e.g., tax liens, mechanic's liens) may have priority over the liens of the secured lenders. Secured lenders should also evaluate the current value of their collateral. This valuation analysis together with the legal review allows secured lenders to determine the extent of their over- or under-collateralization in relation to the obligations owed. The secured lenders also should undertake an analysis of the borrower's insurance programs, including confirming whether the applicable insurance policies covering the collateral and the borrower's business are in effect and whether any applicable endorsements identifying the secured lenders (or the agent) as beneficiaries have been obtained.

*Voting Issues*

The secured lenders also should confirm the voting arrangements by which they are bound. Usually, these provisions are contained in the existing loan documents or, if applicable, the intercreditor agreement or AAL. A multilender credit agreement typically enumerates those issues requiring unanimity and those issues where a vote of a requisite majority can decide on matters that will bind the entire lending syndicate. Issues requiring 100 percent consent typically include any extension of maturity, deferral of principal or interest payments, decrease in the interest rate, or release of a substantial amount of collateral.[9] In certain situations voting may only be required by the particular class of lenders affected by the proposed amendment or waiver.

9. Indeed, for bonds governed by the federal Trust Indenture Act, several recent cases have held that certain nonconsensual impairments of noteholder rights in the context of an out-of-court restructuring are not binding on nonconsenting noteholders. Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 617 (S.D.N.Y. 2014) ("[T]he Trust Indenture Act simply does not allow the company to precipitate a debt reorganization outside the bankruptcy process to effectively eliminate the rights of nonconsenting bondholders."); BOKF, N.A. v. Caesars Entm't Corp., 2015 WL 5076785, at *4 (S.D.N.Y. Aug. 27, 2015) ("[S]ection 316(b) [of the Trust Indenture Act] protects a noteholder's practical ability, as well as the legal right, to receive payment when due."). The decisions have been subject to significant debate among the investor community. In fact, the district court's decision In *Marblegate* was reversed by the Second Circuit Court of Appeals. Marblegate Asset Management, LLC v. Education Management Finance Corp., (No. 15.2124-CVIL), 2017 WL 164318 (2d Cir. Jan. 17, 2017). In a 2-1 ruling, the Court of Appeals construed the Trust Indenture Act narrowly, holding that it only prohibits "non-consensual amendments to an indenture's core payment terms" and does not protect a noteholders' practical ability to receive payment. *Id*.

*Intercreditor Agreement or AAL*

Because a secured lender's restructuring strategy also depends on its rights relative to other lenders under an intercreditor agreement or AAL, counsel should review what rights and obligations the senior priority and junior priority lenders have under these agreements. Special attention should be given to those provisions that restrain the junior priority lenders from taking certain actions or that otherwise require them to support a given action endorsed by the senior priority lenders. These so-called drag-along provisions can apply to a range of activities, including the borrower's use of cash collateral or arrangement of DIP financing in bankruptcy (and the related adequate protection package), a reorganization plan, or asset sales. Counsel should review, among other issues, (i) the scope of collateral and priority of liens; (ii) the amount of debt that may be incurred by the senior lender; (iii) when the respective lenders can exercise remedies; (iv) the circumstances under which lenders are required to release their liens; (v) how proceeds of collateral are applied to repay the debt; (vi) the voting and veto rights of the respective lenders; (vii) existence of buy-out rights in favor of the junior lender; (viii) relative rights of, and restrictions on, the lenders regarding DIP financing and cash collateral use, adequate protection, bankruptcy plans, bankruptcy sales, and credit bidding.

*Other Debt Instruments*

The borrower's other debt instruments also should be reviewed to determine whether, and the extent to which, the rights of other lenders to payments of principal and interest are subordinated to the rights of the secured lenders; to identify any secured obligations of the borrower to other creditors and the collateral securing those obligations; to determine whether covenants in other documents may restrict the borrower's ability to sell assets or otherwise restructure its indebtedness; and to confirm whether any acceleration rights (including based on cross-defaults tied to the secured debt) have been given to the other lenders.

*Major Contracts and Leases*

In addition to the debt documents, secured lenders' counsel also should review the borrower, is major contracts and leases focusing on the counter parties rights in the event of a default by the borrower under the loan documents. These documents may have been reviewed prior to the initial financing, but the focus of this later review will be on the consequences of such a default—for example, whether a landlord may evict the borrower from key locations or inhibit access by the secured lenders that may want to remove collateral. Secured lenders' counsel should also review change of control and assignment provisions in key contracts to determine whether out-of-court restructuring options are feasible, as well as the impact on such contracts, and the limitations on the borrower's ability to assume or assign such contract, if the borrower commences bankruptcy. The secured lenders should consider the actions major suppliers might take, including refusing to ship goods or demanding additional payment guarantees prior to shipment.

*Management Review*

Management of the borrower also should be evaluated to determine whether, in the lenders' judgment, new direction and guidance is needed for the business. Further, employment contracts should be reviewed to ascertain the status of key management employees and to identify, among other things, the incentives those employees have to stay with the struggling company, or conversely, whether they can be terminated by the borrower without prohibitive cost.

### Legal Issues Review

*Fraudulent Transfer Risks*

Legal issues specific to the particular transaction should be reviewed. For example, in acquisition financings, lenders may be faced with the risk that their liens or loans were avoidable as fraudulent transfers. Generally, this risk is considered prior to the closing of the initial financing and the transaction is structured in a manner to mitigate fraudulent transfer risk. In those cases, a review of the projections and other evidence of the solvency of the borrower at the time of the loan, as well as a review of the current financial status of the borrower and the reasons therefor, such as the occurrence of unforeseen events, should be undertaken.[10] Although it may be too late to mitigate a fraudulent transfer risk at the point in time when the borrower is insolvent, the existence of a problem should be identified, and the evidence refuting a possible claim that fraudulent transfers were made should be assembled as early in the process as possible.[11]

*Preference Risk*

To the extent secured lenders received collateral after the initial loans were made or received payments outside the ordinary course of business, these lenders also need to be concerned about the risk of preferences. If the borrower should commence a bankruptcy case, payments made or liens granted to the secured lenders within

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10. The secured lenders should also be mindful of the applicable "reach-back" period in the fraudulent transfer analysis, as many states have fraudulent transfer laws that specify a longer period than the two years provided under federal bankruptcy law.

11. Fraudulent conveyance issues are reviewed in detail in Chapter 11.

the 90-day period prior to the filing may be avoided by the debtor under certain circumstances.[12]

*Recovery of Make-Whole or Prepayment Premiums*

Secured lenders also should evaluate whether their loan documents provide for make-whole or prepayment premiums and the likelihood that the relevant provisions would survive scrutiny by a bankruptcy court. To the extent that the notes issued under the loan agreement are governed by New York law, there is a rule of "perfect tender" prohibiting a borrower from prepaying debt obligations. The parties to the loan, however, can amend this rule to provide for a specific prepayment right for the borrower and the payment of a reasonable premium to the lender. In effect, the "prepayment premium is viewed as the price of the option exercisable by the borrower to prepay the loan and cut off the lender's income stream and insures the lender against loss of the bargain if interest rates decline."[13] Disputes regarding the validity of the secured lender's right to a prepayment premium often arise once a borrower files for bankruptcy. Although the majority of courts have concluded that prepayment premiums are not unenforceable as a matter of law in bankruptcy cases, the loan agreement must contain a "clear and unambiguous clause [calling] for the payment of a prepayment premium . . . even in the event of acceleration of, or the establishment of a new maturity date for, the debt."[14] In the recently decided *Momentive* case, the bankruptcy court observed that "language that would be explicit enough to overcome the waiver of the make-whole upon acceleration" would be "either an explicit recognition that the make-whole would be payable notwithstanding acceleration of the loan or . . . a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to its original maturity."[15] The court in *Momentive* denied the lenders' make-whole claim, finding that the operating loan documents provided for automatic acceleration of the notes upon the bankruptcy filing and that a prepayment by definition could not occur after the accelerated maturity date.[16] Contrary to *Momentive*, the Third Circuit recently held that the borrower's decision to refinance notes as part of a reorganization plan was

12. Transfers made to insiders of the borrower, however, are subject to a one-year look-back period for preference actions. For a discussion of voidable preferences under the Bankruptcy Code, *see* Chapter 11.

13. *In re* Madison 92nd Street Associates LLC, 472 B.R. 189, 195 (Bankr. S.D.N.Y. 2012) (internal citations omitted).

14. *In re* MPM Silicones, LLC, 2014 WL 4436335, at *13 (Bankr. S.D.N.Y. Sept. 9, 2014).

15. *Id.* at *15.

16. *Id.* at *13.

an optional redemption under the loan documents entitling the lenders to receive a prepayment premium despite the automatic acceleration of the lenders' notes.[17]

*Statutory or Regulatory Constraints*

Additional legal issues to be identified at the outset of a restructuring include whether there are any particular statutory or regulatory constraints that would inhibit the secured lenders' ability to effect a workout or proceed against the collateral. Of course, to the extent foreseeable, this should have been considered and dealt with prior to the closing of the initial financing. For example, in the United States, limitations are placed on the foreign ownership of certificated air carriers, television and radio stations, and interstate rail carriers. If the borrower is in one of these industries and foreign lenders comprise a majority of the lending group, the secured lenders as a group may not be able to foreclose on stock pledges or otherwise take control of the assets or operations of the borrower. There also are federal and state restrictions on the ownership of interests in certain other regulated industries and on the ability to hold or pledge certain licenses (e.g., casino gaming licenses, FCC licenses). Foreign lenders also may be subject to regulatory constraints within their home countries that may prevent them from owning or operating a business, or may limit the amount of equity that they are permitted to take in satisfaction of indebtedness.

*Environmental Review*

If the collateral includes real estate or if the borrower operates in an industry in which environmental regulations are particularly relevant, a separate environmental review should be conducted.[18] In a number of early cases, lenders were found liable for cleanup costs under the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). Under CERCLA, joint and several liability can be imposed strictly—without regard to fault—on any party that qualifies under one or more of the statute's defined categories of responsible parties, which includes "owners" of a facility. Although the statute as originally enacted exempted secured lenders from the definition of "owner," some early cases held that the exception was voided where a lender participated in management of a company with contaminated property or actively participated in the company's decisions about waste management.[19] In *United States v. Fleet Factors*, the United States Court of

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17. *In re* Energy Future Holdings Corp., No. 16-1351, 2016 U.S. App. LEXIS 20601 (3d Cir. Nov. 17, 2016).

18. Chapter 24 reviews in more detail the environmental issues arising in a restructuring and the situations in which a secured lender may be liable for environmental cleanup.

19. Guidice v. BFG Electroplating & Mfg., 732 F. Supp. 556, 562 (W.D. Pa. 1989); United States v. Nicolet, 712 F. Supp. 1193, 1197 (E.D. Pa. 1989); Coastal Casting Serv. v. Aron Co., No. H-86-4463,

Appeals for the Eleventh Circuit went beyond previous lender liability cases and held the lender liable on grounds that it merely had the capacity to affect waste disposal decisions.[20] Following a rulemaking by the Environmental Protection Agency and subsequent amendments to CERCLA, the law now provides lenders with greater certainty as to the types of lending activities they may undertake without incurring CERCLA liability. For example, renegotiating the terms of a loan, granting forbearance on a loan, and certain other loan workout activities expressly are exempt from CERCLA liability.[21] Foreclosure actions on contaminated property also are protected as long as the lender makes commercially reasonable efforts to sell the property after foreclosing.[22] To the extent that the environmental risks related to a property make it unmarketable, however, secured lenders must take potential cleanup and carrying costs into account in valuing their collateral. When making decisions about foreclosure, secured lenders also must be aware of applicable state laws, common law, and other federal environmental statutes.

## EARLY WARNINGS

One of the initial steps in any workout is to identify the existence and nature of the problem that caused the deterioration in the credit. Through monitoring a borrower's compliance with the financial covenants set forth in the loan documents, as well as the financial information that customarily is required to be provided by a borrower to its lenders, secured lenders should be able to identify problems at an early stage, before they develop into crises. In situations where there is a healthy dialogue and a readily used avenue of communication between a borrower and its secured lenders, management can serve as an important source of warning.

The borrower's financial problems may stem from any number of causes, the most frequent being a downturn in the overall economy, a downturn in the particular industry in which the borrower does business, a sharp change in commodity prices that has not been properly hedged, or a problem with the borrower's capital structure. If the overall economy is in a downturn and the borrower is not more adversely affected than any of its competitors, the secured lenders may feel that the best solution is to try to ride out the downturn on the assumption that when the economy turns around, the borrower ultimately will emerge as a viable company

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1988 WL 35012, at *4 (S.D. Tex. Apr. 8, 1988); United States v. Mirabile, 15 Envtl. L. Rep. 20,992, 20,994, 1985 WL 97 (E.D. Pa. Sept. 6, 1985).

20. 901 F.2d 1550 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991).

21. *See* 42 U.S.C. § 9601(20)(F)(iv)(VII), (VIII).

22. *Id.* § 9601(20)(E)(ii).

able to compete with others in its industry. If secured lenders adopt this approach, they may request grants by the borrower of warrants or other forms of equity in return for their forbearance, which could have significant value if the borrower's business subsequently improves.

If the downturn instead relates to the specific industry in which the borrower does business, then the secured lenders will need to analyze both the borrower's position within that industry relative to its competitors and the long-term prospects of the entire industry. Is new technology making this industry's products obsolete, or has increased foreign competition narrowed profit margins? For example, in the case of the domestic coal-based energy industry, several factors have contributed to the decline. The development of fracking technology has allowed U.S. energy companies to tap into abundant supplies of previously inaccessible natural gas. This increased supply has caused natural gas prices to decrease, thereby making gas-fired power plants far more cost-effective than coal-burning plants. Moreover, even if prices rebound, a coal renaissance is unlikely given new and pending federal regulations imposing strict limits on carbon emissions. Yet, despite any possibility of a turnaround, there is a tension between the secured lenders' desire that the borrower conserve cash to meet debt service requirements, such as by deferring capital improvements, and the borrower's interest in investing the capital needed to remain competitive in its industry. Because lenders ultimately prefer a competitive borrower, some level of capital expenditures often is agreed to even if it means reducing or delaying debt service.

A particular borrower's problems also can be the result of, or aggravated by, its capital structure. Although the borrower may be profitable from an operating point of view, outsized debt service obligations can create financial difficulties. In those cases, the lenders should consider modifying payment terms, including through rescheduling principal payments, deferring the current payment of interest (i.e., payment-in-kind interest), or, in more extreme cases, converting a portion of the borrower's debt to equity.

## FORBEARANCE AGREEMENTS

Regardless of the cause of a borrower's problems, borrowers will often request a forbearance agreement at the outset of a restructuring process to avoid any interruption in its business by its secured lenders. A forbearance agreement can provide significant benefits not only to the borrower but also to the secured lenders. Indeed, secured lenders should view the forbearance agreement as an opportunity to obtain critical concessions from the borrower, such as:

- acknowledgments regarding the validity of the secured lenders' liens and outstanding claim amounts and the enforceability of the loan agreement;

- amendments to the credit agreement, including additional financial covenants and changes to the interest rate (if a default interest rate would not otherwise be triggered by the occurrence and continuation of an event of default);
- releases and waivers of claims by the borrower;
- acknowledgments regarding any and all events of default that may have occurred and are continuing;
- establishment of milestones for implementation and execution of a turnaround strategy, including retention of professionals (e.g., investment banker to implement a sale process);
- payment of forbearance and legal fees;
- appointment of independent directors or a board observer;
- retention of a chief restructuring officer; and
- granting of additional liens on unencumbered property.[23]

## PROFESSIONALS AND ADVISORS

In conducting the document and legal issues reviews and in evaluating the business plan of the borrower, the lenders should identify any experts outside their institutions to be engaged. The lenders' view as to the cause of the borrower's financial problems will have a large impact on whether the lenders engage outside consultants or experts to assist them in more precisely determining an appropriate and workable solution.

For example, the lenders may perceive the need to engage a restructuring advisory firm specializing in the borrower's industry (and often paid for by the borrower in return for covenant default waivers) to enable them to evaluate the necessity of the company's proposed capital improvements and whether projected cost savings are achievable and comparable to those that other industry members are able to obtain. The advisory firm also will verify the data provided by management, or if the borrower is unable to generate the data or assemble it in the form that the lenders require, obtain access to the borrower's books and records in order to provide that information. This information is important because if the lenders conclude that a particular restructuring will result in a competitive enterprise, they may be willing to make near-term sacrifices, such as the deferral of interest or amortization, in order to ensure or improve the prospects of the ultimate repayment of the loan. On the

23. As discussed earlier in this chapter, lenders should be mindful that these additional liens could be voidable transfers under certain circumstances.

other hand, if they cannot conclude that the borrower can be made viable, they are likely to favor the downsizing or liquidation of the company. The lenders also may retain valuation experts to obtain current valuations of the lenders' collateral or other specified assets of the borrower.

When the lenders lose confidence in existing management, they may turn to a "crisis manager" or "chief restructuring officer" (CRO)—an executive or firm experienced in operating troubled companies on a short-term basis. An experienced CRO has credibility with the lenders and often has a successful track record in turning troubled companies around. Accordingly, its recommendations affect the shape of any restructuring plan. Moreover, a CRO may later become a critical witness for the secured lenders in a bankruptcy proceeding or litigation. Existing management frequently resists having its authority usurped by a CRO. Even when existing management accepts the concept, because of lender liability concerns stemming from any appearance of management and control of the borrower, lenders often are reluctant to designate a particular CRO, and therefore, will provide the borrower with a list of various professionals in whom they have confidence.[24] Lenders may encourage the borrower's engagement of a CRO by conditioning concessions to the borrower on satisfactory management being in place. Support for a change in management also sometimes comes from equity holders eager to protect their investments through the help of a third party.

Despite the lenders' interest in having these additional experts involved in a restructuring, the borrower may object to their engagement for a number of reasons. First, the borrower does not want to pay for them. Professionals generally are expensive and it is especially difficult for a borrower, at the time it is trying to conserve cash, to make substantial cash outlays for new professionals. Particularly irksome to the borrower is the obligation to pay for new professionals to become familiar with a situation well known to the lenders, the borrower, and their existing advisors. However, the costs of retaining these specialists can be added to the outstanding debt owed to the secured lenders. Borrowers also frequently question the value of any professional manager brought into a new situation at the eleventh hour to produce a solution. Another concern many borrowers have is the disruption that is caused by the physical presence of professionals. Initially, the new professionals tend to require a great deal of management's time, which the borrower frequently believes could be better spent addressing the causes of its problems and preparing solutions rather than educating outsiders. Frequently, compromises are reached to limit the number

24. Chapter 19 reviews the legal issues arising when a lender appears to exercise management and control of the borrower.

of consultants and their visits, as well as to defer in whole or in part the borrower's obligation to pay for their services.

## FORMULATION OF THE BUSINESS PLAN

Once the nature of the problem has been ascertained and the appropriate professionals put in place, the lenders and the borrower will need to decide on an appropriate course of action for the company. The first step in this preparation for the future is for the borrower to formulate a business plan. This usually is accompanied by a detailed set of projections covering the next five years, with less detailed projections through the term of the borrower's existing indebtedness, showing a balance sheet, income statement, and statement of cash flows (including new borrowings from, and repayments to, the lenders). Typically, the business plan also indicates any businesses the borrower expects to discontinue or dispose of and an estimate of the resulting proceeds. The business plan forms the basis for the negotiations between the borrower and the lenders as well as for the negotiations among the different classes of lenders.

The formulation of the business plan requires major decisions on the part of the borrower. The borrower can decide to maintain its existing operations but implement new efficiencies in the labor force, inventory management, administration, or the like. Alternatively, the borrower can decide to downsize significantly through sales of plants, divisions, or entire lines of businesses. The borrower's ability to sell assets or otherwise discontinue operations, however, may be restricted in out-of-court restructurings by the terms of its existing debt instruments, and, therefore, may require consents from its senior and other creditors. In an extreme situation, the borrower may propose to liquidate a significant portion of its assets in an orderly fashion to pay its creditors.[25]

## THE NEGOTIATION PROCESS

Once the borrower presents the business plan, various parallel negotiations begin. These consist of borrower-lender negotiations and lender-lender negotiations. The borrower has very little control over the intercreditor negotiations, even though such negotiations greatly affect its destiny.

25. The borrower's determination to sell assets and the creditors' reaction to that determination may help shift the out-of-court restructuring to a chapter 11 case. *See* Chapter 13.

## Senior Lender Group

One set of negotiations occurs among the various senior lenders as they seek jointly to formulate a counterproposal to the borrower's plan. The difficulties inherent in persuading a group of diverse lenders to agree upon a single counterproposal is exacerbated by the large number of holders and the involvement of distressed loan funds in the workout process, many of which may have acquired loans at substantial (though often different) discounts and may be more willing to agree to a solution that allows them to realize a return on their investments quickly, as opposed to the lenders that made or purchased their loans at par and are looking to maintain performing loans on their books and to recover their entire investments.

Voting issues become more complicated if lenders sold participations in their loans to other lenders and gave their participants voting rights. A participation is the sale by a syndicate member of an interest in its loan to another lender that is not a member of the syndicate group and that has not executed the loan documents. Generally, a lender does not disclose to the borrower or the other lenders how much of its loan it has participated out or who its participants are. The participant is not a creditor of the borrower and cannot assert creditor claims against the borrower directly.[26] Rather, the participant must look solely to the selling lender for the exercise of any rights it may have. To protect its interest, a participant may require that the selling lender grant it certain voting rights, generally in funding and payment restructuring decisions. To prevent a participant from having too much leverage in restructuring decisions, many loan documents limit the voting rights a selling lender can give to its participant. Typically, a participant's voting rights are limited to issues that require unanimous lender approval under the loan agreement. Unfortunately, those also are the issues that most often arise in a restructuring. If the participant withholds its consent, the lender then has a choice: either purchase the participant's interest, which the lender probably is unwilling to do because it increases that lender's exposure in a troubled situation, or consent to the restructuring and face a contract claim by the participant. As a consequence of the sale of participations, the number of players in the restructuring process is multiplied, although they may be unknown to the borrower and the other lenders.

The presence of nonbank financial institutions may create a problem when a restructuring requires all lenders to fund ongoing working capital. These institutions generally are term lenders only and historically have been reluctant to provide, have no ability to provide, or in some cases are prohibited by law from providing,

26. *See* Bayer Corp. v. Mascotech, Inc., 269 F.3d 726, 737 (6th Cir. 2001); *In re* Yale Express Sys., Inc., 245 F. Supp. 790, 792 (S.D.N.Y. 1965).

revolving credit. Another complication exists when the lender is prohibited from taking equity.

In a syndicated loan, the question often arises as to whether the agent should be subjected to fiduciary responsibilities or heightened disclosure requirements once the loan becomes troubled. This issue is highlighted during the restructuring process when syndicate members often ask what information the agent had about the borrower's financial difficulties and when that information was first obtained. The loan documents typically limit the agent's duty to disclose financial information regarding the borrower and include undertakings by the syndicate members to rely on their own credit analysis in making decisions about the credit.[27] As a general rule, United States courts are reluctant to hold agents as fiduciaries, finding that the relationship between the agent and other lenders is not, without more, a fiduciary relationship[28] because the parties are sophisticated and engaged in a commercial arm's-length transaction.[29] However, under certain circumstances, the courts also look to the existence of a special relationship between the parties to determine whether any additional disclosure obligations would arise.[30]

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27. *See* Unicredito Italiano SPA v. J P Morgan Chase Bank, 288 F. Supp. 2d 485 (S.D.N.Y. 2003) (express disclaimer in credit agreement precludes lenders' claims that the loan administrators had any duty to disclose information about the borrower's financial condition; although loan administrator knew that borrower's public disclosures were materially misleading, inaccurate, and inadequate, lenders relied upon such disclosures in making their credit decisions). *But see* Merrill Lynch & Co. v. Allegheny Energy, Inc., 382 F. Supp. 2d 411 (S.D.N.Y. 2003) (general disclaimer of representations and warranties in purchase agreement does not bar claim by buyer of energy commodities trading business for fraudulent inducement where matters misrepresented were particularly within the knowledge of seller).

28. *See* Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 763 F. Supp. 36, 45 (S.D.N.Y. 1991) (no fiduciary relationship exists under loan participation agreement unless expressly and unequivocally created by contract); *see also* Guar. Sav. & Loan Ass'n v. Ultimate Sav. Bank, F.S.B., 737 F. Supp. 366, 370 (W.D. Va. 1990) (fiduciary obligations are not created by loan participation agreements between banks unless language of agreement manifests intention to create such obligations).

29. *See* Banque Arabe et Internationale D'Investissement v. Md. Nat'l Bank, 57 F.3d 146, 158 (2d Cir. 1995) (lead bank has no duty to disclose facts regarding delay and regulatory approval of borrower's condominium conversion plan where banks engaged in arm's-length negotiations and participation agreement explicitly disclaimed any reliance by participating bank on lead bank's information regarding its credit analysis); First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., 919 F.2d 510, 514 (9th Cir. 1990) (in context of loan participation agreements among sophisticated lending institutions, fiduciary relationships should not be inferred absent unequivocal contractual language).

30. *See* EBI 1, Inc. v. Goldman Sachs & Co., No. 61 slip op. (N.Y. June 7, 2005) (fiduciary duty existed between the underwriter of an initial public offering and the issuer based on the underwriter's

## Private Equity Sponsors

In the circumstance where the borrower is a portfolio company of a private equity, that company is known as a private equity fund sponsor ("PE sponsor"). The PE sponsor is an important player in the negotiation dynamic, in part because it could be viewed as an additional source of potential financing.[31] It is difficult to predict how the PE sponsor will act in a restructuring, especially in those circumstances where equity has run out of money. However, it is also important for lenders to understand the incentives influencing the PE sponsor. According to a 2011 study, for example, there are several reasons why the PE sponsor can expect a positive role in a restructuring context. When value declines, PE owners have strong incentives to correct the decline to preserve their equity stake, often using such corrective methods as committing capital to support the distressed company. PE sponsors also have an incentive to preserve their reputations with lenders and future investors, even when they may lose an insolvent firm during restructuring.[32]

PE sponsors will also want to negotiate in good faith with the lenders to "establish[ ] a defense to many of the causes of action that the sponsor could face in the event of a bankruptcy," including claims for breach of fiduciary duty.[33] Another important consideration in the negotiation process is whether there might be tax implications for the borrower, the lenders, and the PE sponsors. For example, a restructuring can be organized in a way that minimizes tax obligations and preserves tax attributes.

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separate advisory relationship with the issuer); Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87 (2d Cir. 2001) (finding that the special relationship of trust and confidence between securities broker and investors in a healthcare financing venture extended beyond the typical arm's-length transaction and was sufficient to support recovery for negligent misrepresentation where defendant/broker had special knowledge about the venture).

31. Christopher W. Kirkham & Jennifer M. Taylor, *Working Through a Workout: A Practitioner's Guide from the Perspective of Private Equity Sponsors, Venture Capital Funds and Other Significant Equity Investors*, 5 Hastings Bus. L.J. 355, 355–366 (2009).

32. Edie Hotchkiss, David C. Smith, & Per Strömberg, *Private Equity and the Resolution of Financial Distress* 1–3 (AFA 2012 Chicago Meetings Paper; ECGI - Finance Working Paper No. 331/2012, 2014), available at https://ssrn.com/abstract=1787446.

33. *See* Kirkham, *supra note* 31, at 360.

### Other Creditors

At the same time as these intrasyndicate discussions are proceeding, the agent, on behalf of the senior lenders, will be conducting negotiations directly, or through the borrower, with the borrower's other creditors, including subordinated lenders, unsecured lenders, and key vendors. The extent of the senior lenders' collateral coverage and the terms of the subordination of the debt owed to other creditors will determine how much leverage the senior lenders have vis-à-vis other classes of creditors.

### Intra-Institution

Still another set of negotiations will be that taking place within each institution. Although a particular proposal may make sense for the borrower and be acceptable to most lenders, internal constraints at a particular institution, such as those relating to returns on investment, capital adequacy, and the classification of the credit for regulatory purposes, may make a lender unwilling to support the proposal, necessitating the renegotiation of the entire restructuring, or at the very least, particular aspects of it. In addition, nonbank financial institutions, institutional investors, and hedge funds often view their initial loans purely as investment decisions and do not have the same interest as banks in maintaining a working relationship with the borrower. Finally, if the lender is a fund, the proposed restructured loan may not meet its investment criteria, making it more resistant to fundamental changes in the nature of its investment.

## OPERATIONS DURING THE RESTRUCTURING PERIOD

While the borrower continues to operate its business during the restructuring period, certain issues arise in connection with the lenders' ongoing involvement with the borrower and its operations. Two of the most common issues involve approving interim budgets and expenditures and responding to creditors' inquiries.

As a general rule, lenders do not approve budgets and expenditures, but rather, analyze the factors that led the borrower to arrive at its conclusions. In particular, lenders are advised not to approve or disapprove payments to particular creditors, especially if the funds will be used to pay the lenders instead of other creditors. Indeed, in a bankruptcy case, the lenders may be exposed to equitable subordination claims by the creditors that the borrower did not pay.[34]

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34. For a discussion of the equitable subordination of the claims of senior lenders, *see* Chapter 19.

Lenders to troubled companies frequently are contacted by other creditors, particularly trade creditors and equipment lessors, to determine the lenders' views of the company's financial situation and the status of its lending arrangements. As a legal matter, lenders generally have no duty to respond to these inquiries. However, if they choose to respond, they must respond truthfully.[35] There is always the question, however, of how fully the lenders must respond. Lenders do not wish to be misleading, but as a practical matter they also do not want to create an inaccurate or overly bleak impression, particularly early in the restructuring process, as the discontinuance of trade credit almost always precipitates another crisis. In addition, the borrower's development of an appropriate communications plan (both to key vendors and its employees) can help the lenders navigate through these issues, while also helping to stabilize the business and preserve value.

The lenders also will be faced with decisions concerning whether to fund ongoing working capital requirements during the restructuring. Although they may not be obligated contractually to do so because of existing defaults under the loan documents, to deprive the borrower of working capital may adversely affect the viability of a restructuring if the company is thereby compelled to reduce expenditures needed to keep the business operating. As a general principle, the lenders need sufficient confidence in the borrower and its viability to enable them to conclude that, as a result of additional funding, they will recover not only the funds advanced but an increased portion of their existing debt. Having made the determination to fund into a default situation, the lenders should seek to ensure that any postdefault extensions of credit are made pursuant to strict conditions that are complied with at each borrowing. This serves to help protect from attack by the borrower any subsequent decision of the lenders to discontinue funding.

## OUT-OF-COURT RESTRUCTURING

Unlike a bankruptcy, an out-of-court restructuring requires the consent of all lenders whose principal and/or interest is being deferred or converted to equity. For this reason, an out-of-court restructuring rarely occurs in cases where the borrower has public debt, except where a high percentage of holders of the public debt consents

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35. Fraud is another basis for a creditor (that relied on false information to its detriment) to seek equitable subordination of the lenders providing the false information. *See* Chapter 17. Moreover, the lender that provides fraudulent information to another creditor, or that fails fully to disclose material information in its possession once it undertakes to disclose any information, may be liable for the other creditor's loss. Gen. Motors Acceptance Corp. v. Cent. Nat'l Bank, 773 F.2d 771 (7th Cir. 1985); Cent. States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405, 1409 (6th Cir. 1984).

to the restructuring plan.[36] In that instance, the nonconsenting holders of public debt represent a small dollar amount and it is not material to the borrower's financial status that they continue to be paid in accordance with their contractual terms. Generally, however, any protective covenants contained in the public debt indenture are deleted from the indenture through indenture amendments that are approved by the same majority of holders that consented to the restructuring plan.[37]

## EXERCISE OF REMEDIES

The legal rights of lenders to exercise remedies against particular items of collateral largely are governed by state law. The nature of the process depends in significant part on the type of collateral that is involved. However, it is not unusual for the borrower or the borrower's other creditors to commence a bankruptcy case when the lenders seek to exercise their remedies. The bankruptcy filing creates an "automatic stay" that prevents any lender or creditor from exercising its remedies against the property of the borrower without a bankruptcy court order that may be entered only after notice to interested parties and a hearing.[38]

36. *See* Chapter 1. "Prepackaged" chapter 11 cases are discussed in Chapter 13.

37. The method of obtaining a consensual restructuring of publicly held debt through a tender or exchange offer is detailed in Chapter 3. Federal securities laws issues regarding the "deemed exchange" of public debt are covered in Chapter 18.

38. The features of the "automatic stay" are discussed in Chapter 5.