

**EARLY STAGE FORBEARANCE DOCUMENTATION
AND WORKOUT PROCEDURES**

**ICLEF COMMERCIAL LOAN DOCUMENTATION SEMINAR
JUNE 20, 2001**

BACKGROUND

On December 31, 1998, Borrower and Bank, as agent for a group of three lending institutions (including Bank itself), closed the loan documentation for a \$30,000,000 loan facility consisting of a \$6,000,000 Revolving Loan, a \$12,000,000 Term Loan A and a \$12,000,000 Term Loan B. Bank obtained a lien upon and security interest in all of the real and personal property of Borrower and its sole Subsidiary. At the closing, Mezz Lender provided a \$5,000,000 mezzanine loan (which was contractually subordinated to the loans of the Senior Bank Group) and Equity Sponsor provided \$20,000,000 of capital. The proceeds of the senior loans, mezzanine loan and capital investment were used to permit Borrower to buy substantially all of the assets of Target, including all of the outstanding capital stock of Subsidiary, as well as to satisfy the transaction expenses associated therewith.

The following is a dramatization of the phone calls which take place, the issues which arise and the legal documentation which is prepared as a result of Borrower failing to achieve its original projections. This dramatization focuses upon the early stages of the workout and is intended to educate attorneys and loan officers about the types of issues that may be encountered and the use of appropriate legal documentation.

THE FIRST PHONE CALL -- NOTHING TO WORRY ABOUT (JANUARY 31, 2001)

Bank Officer: Dave, remember the loan we closed on December 31, 1998? We just got Borrower's unaudited financial statements for the year ended December 31, 2000 and they show violations of a couple of the financial covenants contained in the Credit Agreement. Can you prepare a waiver letter or a reservation of rights letter or a forbearance agreement or something like that? We here at Bank are convinced that Borrower simply had a bad quarter because one of its customers went bankrupt and defaulted on a significant receivable. The projections still look good and we expect Borrower to achieve the covenant levels contained in the Credit Agreement as of March 31, 2001, June 30, 2001 and thereafter.

The attorney for the Bank must choose the appropriate documentation.

"Waiver Letter": A letter in which a lender waives existing event(s) of default and relinquishes all rights and remedies available to it as a result of those event(s) of default. The waiver letter should make clear that the lender's election to waive the rights and remedies as a result of the existing event(s) of default will not obligate the lender to waive rights and remedies in the future based upon similar or other events of default.

"Reservation of Rights Letter": This letter is to be used when an event of default has occurred and the lender has not yet decided what course of action it will take. It should set forth the events of default with specificity and should make clear that the lender is not waiving any rights or remedies, but instead may elect to exercise any and all rights and remedies available to it under the loan documents or applicable law at any time. This "wait and see" letter is prepared to preclude borrowers from saying: "You knew about the event of default and did nothing about it; therefore, you waived the event of default."

"Forbearance Agreement": An agreement executed by a borrower and a lender pursuant to which the lender agrees to forbear from exercising any rights and remedies available to it (but not waive these rights and remedies) as a result of certain specified events of default until a specified time or the occurrence of specified events. A forbearance agreement may provide that it will mature into a waiver if the borrower achieves specified results or the equity sponsor elects to contribute additional equity. This agreement gives the

borrower breathing room for a defined period. The lender should get something in exchange for the breathing room, such as a release, a fix to lingering documentation issues or collateral holes, a commitment for new equity from the shareholders, borrower's agreement to engage a consultant, borrower's agreement to try to sell assets, etc.

Bank Attorney: If you are pretty sure that this is an isolated problem I will prepare a waiver letter. I assume that "requisite lenders" will approve the waiver, but I need for you to confirm that. Were the financial covenants under the mezzanine loan documents also violated? If so, we will want Mezz Lender to execute a similar waiver. We do not want to place ourselves in a situation where we have waived a default, but Mezz Lender is still entitled to take action.

THE SECOND PHONE CALL -- I'M LOSING CONFIDENCE IN MY BORROWER (APRIL 30, 2001)

Bank Officer: Uh, Dave, the Borrower, I mean . . . do you remember, um, we sent a waiver letter? Well, . . . , um, you're not going to believe this, but we just got March 31, 2001 financial statements and this time Borrower blew all of the financial covenants. They also blew all of the financial covenants in the mezzanine loan documents. Now they're telling us that they're not sure if they are going to achieve any of the financial covenants for the rest of the year. We've asked for updated projections but we don't expect to receive them for about two months. Oh, by the way Dave, there is one more thing I wanted to mention to you. As you may recall, semi-annual interest of \$275,000 is payable on the mezzanine loans on May 15. I don't think that I would be too happy if the Mezz Lender received payment at a time when all of our financial covenants have been breached and Borrower has yet to provide us with realistic updated projections. What do you think we should do?

This second phone call highlights a variety of issues which typically need to be addressed by bank counsel. First, bank counsel must always be cognizant of the actions which may be taken unilaterally by the agent for the bank group, versus the actions which may be taken only with the approval of "requisite lenders" (a specified percentage of the bank group), versus actions which may be taken only with the approval of all of the members of the bank group. Second, bank counsel must always think about the rights available to other creditors of the borrower, in many cases, most importantly, the mezzanine lender. Addressing the first issue will require a thorough review of the senior loan documents and addressing the second issue will require a thorough review of both the mezzanine loan documents and the subordination or intercreditor agreement between the holders of the senior debt and the holders of the mezzanine debt. As a very important aside, with respect to the first issue, even if a specific action can be taken with the approval of two of the three members of the bank group, the majority members should think very hard before taking action which would upset the sole minority member. It is likely that future actions which are desirable to the bank group as a whole will require the approval of all members and it is often difficult to obtain that approval when the views and desires of one or more members of the bank group were ignored or steamrolled on a prior occasion.

Bank Attorney: First, are all of the members of the Senior Bank Group on the same page? Assuming that you and the other members of the Senior Bank Group are still willing to honor revolving loan requests, I would suggest sending a reservation of rights letter in which we reserve our rights until we have been provided with information, in the form of updated projections. At that time, you and the other members of the Senior Bank Group can make a more informed decision as to how we should proceed. In other words, at that time, we can decide whether we are willing to revise the financial covenants, whether we will require the Mezz Lender to defer interest and whether we will require the Equity Sponsor to contribute additional capital.

Second, we should find out if Mezz Lender will voluntarily agree to defer its right to receive the May 15 interest payment. If they won't you'll have to start a "payment block" under the Subordination Agreement between you and Mezz Lender.

Unfortunately, however, if I recall correctly, the Subordination Agreement limits you to one payment block for every 360-day period.

THE THIRD PHONE CALL -- SOME INTERESTING DEVELOPMENTS (JUNE 15, 2001)

Bank Officer:

I just received an interesting call from the Equity Sponsor. Equity Sponsor indicated that they were thinking about a variety of solutions to Borrower's problems, including the infusion of additional equity, as well as the possible sale of Borrower. Equity Sponsor also indicated that it has hired a workout consultant to analyze Borrower's problems and to determine an appropriate market value in the event that a buyer for the business can be identified. Equity Sponsor has indicated that it would like for the members of the Senior Bank Group as well as Mezz Lender to forbear from exercising any rights and remedies available to them for the next six months in order to allow Consultant to complete its analysis. During that six-month period, Equity Sponsor has asked us to defer receiving monthly amortization payments with respect to our term loans and Equity Sponsor has also asked that Senior Bank Group continue to make revolving loans to satisfy Borrower's working capital needs. Dave, I'm glad to see that Equity Sponsor is being proactive, we have some sponsors who don't realize when problems exist, but I am not sure how I want to proceed. Also, has anybody mentioned to you that a couple members of the Senior Bank Group have moved the credit to their "special assets" area?

It is at this point in our dramatization that significant decisions must be made. If the members of the senior bank group are not prepared to conduct a liquidation and if significant deterioration is not likely, entering into a three-month or six-month forbearance agreement seems like the most viable option. Such a forbearance agreement might, among other things: (a) provide for the members of the senior bank group to forbear from exercising rights and remedies available to them as a result of the existing events of default, (b) provide that the forbearance will terminate if borrower fails to provide certain specified financial data on a periodic basis, (c) provide that such forbearance will terminate if borrower fails to achieve certain interim financial covenant hurdles, (d) limit the amount of additional revolving loans that the members of the senior bank group will be required to make, and (e) provide that equity sponsor will execute a "capital call agreement" which commits equity sponsor to make additional capital contributions (or deeply subordinated loans) under certain circumstances.

Bank Attorney:

Let me ask you a number of questions. Don't answer them now, but jot them down, think about them and call me back in the next few days:

- 1. Have you thought about hiring your own consultant so that you have an accurate valuation of Borrower? I'll look at the loan documents to see if we can pass the cost of a consultant on to Borrower.*
- 2. Do you have any sense of whether the value of Borrower is deteriorating? In other words, if you do agree to provide additional working capital loans, will you be throwing good money after bad? What will happen if you don't provide funds? Will Borrower run out of cash and, if so, when?*
- 3. Is there any element of seasonality to Borrower's business, such that once you begin providing additional working capital, you will need to continue to do so to allow Borrower to get through its "season" in order to permit you to have any realistic chance of seeing a repayment of those newly advanced funds?*
- 4. I have asked you this before, but do you have a sense as to whether all members of the Senior Bank Group are on the same page? Is anybody yelling that it is time to conduct a foreclosure sale or place Borrower in a chapter 11 proceeding?*

5. *Once again, what are the views of Mezz Lender at this time?*
6. *If Borrower's assets were liquidated today, do you have any idea of what your loss would be?*
7. *Think back to the original closing. Did we not get a lien on any assets? Did we negotiate away anything of importance? Now is the perfect time to fix things.*

THE FOURTH PHONE CALL -- DAVE, ITS BEEN FUN (JULY 5, 2001)

Bank Officer: Dave, stop working on the forbearance agreement, the matter has just been moved to our "special assets" group and I understand they have some different views as to how we should proceed. Please call the head of our special assets group as soon as you can. Thanks for your counsel and I'll be sure to send my next deal to you.

The End (or maybe just the beginning)

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OTHER FREQUENTLY ENCOUNTERED ISSUES

1. It is not uncommon for Borrower to state: *"We need a waiver from the Senior Bank Group in order to obtain unqualified audited financial statements."*
2. Members of the Senior Bank Group will ask: *"Our Credit Agreement tests financial covenants on a quarterly basis. We just received the financial statements for the first month of the quarter and based upon that month's performance alone, we know for sure that Borrower will not be able to achieve its financial covenant levels for the quarter ending next month. Can we call a default now?" If not, can we at least tighten the borrowing base?*
3. Statement from members of the Senior Bank Group: *"Even though Borrower has violated the Credit Agreement, Borrower is claiming that the Senior Bank Group is overreacting to the situation and should be willing to provide not only the revolving loans contemplated the Credit Agreement, but additional loans as well. Borrower's tone smacked of lender liability allegations. Can I require them to sign a release or include a release in a forbearance agreement?"*
4. Statement of members of the Senior Bank Group to the agent bank's counsel: *"I understand that all members of the bank group want to waive certain defaults and that my institution is the only one not willing to do so. I also understand that you are drafting the waiver letter. Just whose lawyer are you? Can you draft that waiver given that my institution is not on board?"*

If you have any questions or would like further information on these issues, please contact David M. Mason at (312) 201-3915 or via e-mail at David.Mason@goldbergkohn.com.

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