

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

DAVID M. MASON

The healthy economy of the latter half of the 1990s meant that there were relatively few defaulted loans. In contrast, the economic slowdown of the past few years has resulted in more and more defaulted loans, requiring loan officers and lawyers to utilize workout documentation and procedures that have been mothballed for years. For those loan officers and lawyers who did not participate in the loan workouts of 1990 through 1993, the author has prepared a dramatization to highlight the documentation and procedures associated with the "early stages" of a workout. The phrase "early stages" means the period of time after the loan documents have been violated but before foreclosure and bankruptcy merit serious consideration by the parties.

SETTING THE STAGE

On December 31, 1998, Borrower and Bank, as agent for a group of six lending institutions (including Bank itself), closed the loan documentation for a \$60,000,000 loan facility consisting of a \$12,000,000 Revolving Loan, a \$24,000,000 Term Loan A and a \$24,000,000 Term Loan B. Bank obtained a lien upon and security interest in all of the real and personal property of Borrower. At the closing, Mezzanine Lender provided a \$5,000,000 mezzanine loan (which was contractually subordinated to the loans of the Senior Bank Group) and Equity

David M. Mason is a principal with Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd., in Chicago. He may be reached at david.mason@goldbergkohn.com.

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

Sponsor provided \$30,000,000 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, as well as to satisfy the transaction expenses associated therewith.

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

Loan 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.

This phone call demonstrates the loan officer's relative unfamiliarity with the loan documentation associated with the early stages of a workout. The loan officer recognizes that some type of documentation is needed as a result of the financial covenant violations, but is not sure exactly what documentation is appropriate. It is up to the bank's lawyer to advise his client of the menu of available documentation and the appropriate times at which each type of document should be used. In general terms, the menu of appropriate documentation consists of the following:

"Waiver Letter"

A letter in which a lender waives an existing event or existing events of default and relinquishes all rights and remedies available to it as a result of

BANKING LAW JOURNAL

the default. A waiver letter is to be used when the lender is not bothered by the loan document violations which have occurred to date, the lender is not interested in exercising any rights as a result of those violations and the lender is not interested in requiring its borrower to alter its behavior in any way. The waiver letter should make clear that the lender's election to waive the rights and remedies as a result of the existing event or existing events 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 existing event or 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, by your inaction 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. In exchange for the breathing room granted to the borrower, the lender will usually get something in return, 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 in order to pay down the loans, etc.

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

Regardless of the documentation chosen, this 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 four of the six members of the bank group, the majority members should think very hard before taking action which would upset the two minority members. 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.

In the dramatization, because the loan officer indicated that the loan document violations are likely to be an isolated instance, the waiver letter seems like the appropriate documentation. Accordingly, the following would be an appropriate response to be made by the lawyer.

Bank Lawyer: 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.

BANKING LAW JOURNAL

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

Loan Officer: Dave, do you remember that we sent a waiver letter a few months ago? Well, 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?

Unlike the first phone call in which the loan officer expressed a lack of concern about the loan document violations, in this phone call the loan officer is both uneasy and troubled. The phone call indicates that the loan officer properly asked its borrower for updated projections in order to obtain the borrower's best sense of the direction in which financial performance is headed. Unfortunately, it appears as if those projections will not be available for some time. Accordingly, from the menu of available loan documentation set forth above, the reservation of rights letter now seems like an appropriate choice.

Because a reservation of rights letter does not contain any binding obligations, the agent bank can usually send it without prior approval of the bank group. Nevertheless, it is appropriate for the agent bank to consult with the other members of the bank group to obtain their views on the way in which the loan facility should be managed. It is also appropriate to engage in conversation with the mezzanine lenders in order to get a sense of their view of

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

the situation and the manner in which they are likely to approach it. Hopefully those conversations will result in a voluntary agreement by the mezzanine lender to defer the due date of its May 15 interest payment. If such an agreement is not forthcoming, however, the lender must consider invoking its contractual rights under the subordination agreement to “block” the mezzanine lender from receiving interest on the scheduled due date. To the extent that all parties (borrower, members of the senior bank group and holders of the mezzanine debt) are willing to engage in constructive dialogue, it is almost always beneficial to conduct those conversations in order to permit each party to articulate its intended actions and expectations from one another.

Bank Lawyer: *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. If one or more members of the Senior Bank Group are not willing to continue to make revolving loans at this time, you need to determine whether Borrower has enough cash to continue to operate its business or whether a liquidity crisis (which will most likely cause the onset of a bankruptcy proceeding) is likely or possible.*

Second, we should find out if Mezz Lender will voluntarily agree to defer its right to receive the May 15 interest payment. If it won't defer voluntarily you'll have to start a “payment block” under the Subordination Agreement between you and Mezz Lender. Unfortunately, however, if I recall correct-

BANKING LAW JOURNAL

ly, the Subordination Agreement limits you to one payment block for every 360-day period. If my recollection is correct you will need to think about whether now is the time to use the one payment block available to you or whether it is better to save it for a later date.

Finally, I want you to begin to think about a few things in case Borrower's financial condition deteriorates. Do you have a good sense of the amount for which Borrower's business can be sold as a going concern and the amount that you could realize if forced to conduct a foreclosure sale of Borrower's assets? Next, do you want us to review the loan documentation files to verify that your liens and security interests were properly perfected, to determine whether any collateral exists upon which you do not have a lien or security interest and to determine whether the loan documentation contains any provisions which were originally agreed to at the request of Borrower but which now, given Borrower's failure to comply with the loan documents, are worthy of amendment? It is never too early to conduct a thorough review of the files so that we are well prepared in the event of continued financial deterioration.

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

Loan 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

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

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:

- 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,
- provide that the forbearance will terminate if borrower fails to provide certain specified financial data on a periodic basis,
- provide that such forbearance will terminate if borrower fails to achieve certain interim financial covenant hurdles,
- limit the amount of additional revolving loans that the members of the senior bank group will be required to make,
- 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,
- provide that borrower will share the results of the consultant's analysis with the senior bank group,

BANKING LAW JOURNAL

- provide that borrower will permit the senior bank group's own consultant with access to the borrower's facilities and financial records,
- provide that the forbearance will end if the mezzanine lender takes any action against the borrower,
- amend the provisions of the loan documents which permit the equity sponsor to receive a monthly management fee,
- amend the provisions of the loan documents which limit the ability of members of the lending group to sell their loan positions,
- amend the provisions of the loan documents which allow the redemption of stock from members of the management team, and
- contain a release from the borrower and the equity sponsor from all actions taken by the members of the bank group in administering the senior credit facilities prior to the date of the forbearance agreement.

The list of possible provisions is endless. Now is the time for the bank group to brainstorm about what it wants to exchange for the requested forbearance.

It is worth noting that the loan officer mentioned that a couple members of the bank group have moved the credit facilities to their "special assets" area. As a result, aside from addressing all of the issues which need to be addressed, it is now the job of the loan officer to educate the personnel from these special asset areas about the history of the credit facilities, and the personalities involved.

Bank Lawyer: 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*

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

- 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 recovery 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.*

Think about the foregoing. My gut is that after consulting with the other members of the bank group and after getting a sense of Mezz Lender's willingness to stand by for the next three to six months, we will enter into some type of a forbearance agreement with Borrower. The answers to the questions that I have posed will permit us to draft that forbearance agreement and obtain a few things for the members of the Senior Bank Group in exchange for the willingness of the Senior Bank Group, if that willingness exists, to forbear for some period of time.

BANKING LAW JOURNAL

THE FOURTH PHONE CALL — DAVE, IT'S BEEN FUN (JULY 5, 2001).

Loan 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)

* * * * *

OTHER FREQUENTLY ENCOUNTERED ISSUES

There are a variety of other issues that banks and counsel frequently encounter in these circumstances.

For example, it is not uncommon for a borrower to state: *"We need a waiver from the Senior Bank Group in order to obtain unqualified audited financial statements."*

When a borrower makes this statement, the lender must ask for a list of those people who require delivery of borrower's audited financial statements and an idea of the people on that list who would alter their behavior if they received qualified (as opposed to unqualified) financial statements. Most often borrowers will state that significant suppliers require the delivery of audited financial statements and that many of those suppliers will cease providing trade credit if the audited financial statements are qualified. If that is in fact the borrower's response, the senior bank group must weigh the risks associated with waiving existing events of default (thereby giving up rights and remedies but permitting the borrower to obtain unqualified financial statements and thus no cessation of trade credit), versus not agreeing to a waiver (thereby preserving rights and remedies but exposing borrower and the senior bank group to the consequences of suppliers ceasing to provide

EARLY STAGE WORKOUT DOCUMENTATION AND PROCEDURES

trade credit).

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?*

Lawyers may disagree on the response to this question, but the most conservative advice is that the bank group may not call a default if there is a theoretical possibility that the borrower’s performance in the second and third months of a quarter can outweigh the poor performance of the first month thereby resulting in financial covenant compliance for the entire quarter. Other lawyers may ignore theoretical possibilities and permit the bank group (maybe in reliance upon a material adverse change clause) to call an event of default if they are absolutely sure that as a practical matter financial covenant compliance cannot be achieved. As to the second question regarding tightening of the borrowing base, the bank group can do only that which it is permitted to do by the loan documents. If the loan documents provide the bank group with the flexibility to tighten the borrowing base, then the bank group may tighten the borrowing base. If the loan documents do not so provide, the bank group does not have the unilateral ability to tighten the borrowing base simply because the borrower had a bad month. The precise language of the loan documents will guide the answers to these questions.

Members of the senior bank group also may state: *“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?”*

The bank group never has the unilateral ability to require a lender to sign a release, but the bank group can and should use any leverage available to them to extract a release. Usually that leverage is available at the time when a borrower requests a waiver or forbearance.

Finally, members of the senior bank group may say to the agent bank’s

BANKING LAW JOURNAL

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?"*

In most cases, the agent bank retains counsel to represent it and only it. Members of the bank group, from time to time, retain their own counsel. While the interests of the agent bank and the members of the bank group are usually aligned such that the actions taken by counsel to the agent bank result in benefits to the bank group at large, it is possible that disputes will arise among members of the bank group or between the agent bank and individual members of the bank group. In anticipation of those situations, it is usually wise for the agent bank to have its own counsel. There are, however, situations in which a member of the bank group asks the agent bank to permit the agent bank's counsel to represent both the agent bank and the bank group member, on a joint basis. In those situations, counsel must make clear to the agent bank and the bank member that in the event of a dispute between the agent bank and the bank group member, counsel will have to withdraw, thereby requiring each institution to find its own new counsel. As a result of the foregoing analysis, assuming a situation in which the agent bank has its own counsel, it is appropriate for the lawyer to advise the bank group member that the lawyer is counsel to the agent bank only and that she may draft the waiver notwithstanding the objections of the one bank group member.