Cover Story

Defending the 'Fort' in a Turnaround

Lender's Counsel Can Play Key Role

By Michael P. Bonner, Partner, Stradley, Ronon, Stevens & Young, LLP

A turnaround is a lender's equivalent of a general defending a fort against attack. As such, a lender's counsel must be prepared to do battle, while at the same time seeking an amicable resolution that keeps the client's "fort" unharmed and benefits other parties involved to the greatest extent possible. To accomplish this, the attorney must be committed to the turnaround and share the lender's sense of day-to-day urgency as the process progresses.

This article explores the role of a lender's counsel in a turnaround, which for purposes of this discussion includes workouts, liquidations, bankruptcy, or other actions that arise in connection with a troubled borrower. Some due diligence activities that the attorney must undertake after first learning of a troubled borrower are reviewed, as are some of the specific issues and actions that arise in the early stages of a bankruptcy.

Mapping Strategies

A lender's counsel in a turnaround offers advice on matters such as the client's overall strengths and weaknesses in the credit, including the implications of being undersecured or oversecured; the lender's bargaining power with the borrower and third parties; and advantages and disadvantages of a bankruptcy filing. To be truly effective, however, a lender's counsel must do more than simply provide sound legal advice and draft appropriate legal documents. The attorney must also have the proper attitude, be creative, and possess effective communications skills.

A lender's counsel must be an imaginative and independent thinker. The attorney should be neither a "yes man" who agrees to whatever a lender contemplates nor a "no man" who deems as too risky any action that is considered. Rather, a lender's counsel should explain applicable risks and rewards of actions and then offer creative options to solve the problems at hand. Although the ultimate business decision about any proposed action rests with the lender, the attorney should participate actively in the decision making process, not just wait passively for instructions from the lender.

For example, in a non-bankruptcy liquidation about a year ago, a borrower had been unsuccessful in collecting a large debt from an account debtor. The account debtor was unwilling to pay because one of the borrower's unpaid suppliers had threatened to place liens on the account debtor's assets. The account debtor feared that he would be forced to pay off the debt twice—once to the borrower and then again to the supplier—to have the liens removed.

In that case, a shortfall in selling the inventory and collecting the receivables made it unlikely that the lender would ever be paid in full. It was also unlikely that the supplier, as a junior-secured party, would receive any money at all. The lender's counsel suggested that the lender agree to reimburse the account debtor if a court, in a final and non-appealable order, required the account debtor to pay any money to the supplier.

This guarantee provided the account debtor with the comfort level it was looking for, and it paid its debt to the borrower, reducing the outstanding obligations owed to the lender. In that case, the reward of payment far outweighed the risk of a potential reimbursement. To date, no liens have been filed against the account debtor, and no claims for reimbursement have been made.

Shoring Up Positions

The lender's counsel also must be able to communicate effectively with all parties

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involved in the turnaround. These include the lender's business people and in-house counsel, the attorney for the borrower, guarantors, principals, subordinated creditors, the crisis-management specialist and, in a bankruptcy, the unsecured creditor's committee. Effective communications foster cooperation among the parties, which usually provides the best chance for a turnaround that benefits all involved. It has been said time and again that no one has ever completed a turnaround alone.

With that in mind, what should a lender's counsel do upon learning that a borrower has been put on the "watch list," is experiencing financial difficulties, or is contemplating filing bankruptcy?

The first thing is to order Uniform Commercial Code (UCC), tax, and judgment searches of the borrower and any other obligors. If real estate is involved, a title search also is necessary. As a threshold matter, these searches and title reports show whether the lender is properly perfected in all of the security contemplated by the specific credit facility – that it has completed all of the necessary legal steps to stake its claim to the collateral.

Obviously, if the lender is not properly perfected, immediate action must be taken to correct the situation. The searches and title report also will reveal whether liens, encumbrances, or judgments exist that may negatively affect the lender's priority status. These issues also must be addressed immediately.

As part of the reviews, it is important for counsel to ensure that the lender has filed properly in the state of incorporation or formation of the borrower. The transition rules of UCC Revised Article 9 permit a lender to retain its perfected security interest in the borrower's collateral if it took the proper steps for perfection by filing under the old Article 9. This typically meant that the lender filed in all jurisdictions in which the borrower's assets were located, which sometimes did not include the borrower's state of incorporation or formation.

This is important because, when disposing of collateral under Section 9-611(c) of Revised Article 9, a secured party must notify any other secured party that has filed a financial statement against the borrower as of that date. The potential pitfall is that for a financing statement to be effective for purposes of notice, it must be filed in the appropriate office under Revised Article 9, which for most borrowers is in the state in which they incorporated or formed.

This means that although the lender's filing under old Article 9 satisfies Revised Article 9's requirements for perfection purposes, it does not meet the revised law's requirements for notice purposes. If that situation arises, lender's counsel should immediately file an in-lieu financing statement in the borrower's state of incorporation or formation.

The next step for lender's counsel is to review the client's credit files and discuss with the lender the current status of the credit. Among the issues the attorney should investigate are whether:

1. Negotiated changes to the lender's form of loan documents, such as additional notice requirements or cure periods, require the lender to modify its course of action
2. Any dealings between the borrower and lender may result in the waiver by the lender of an otherwise valid right
3. Premium pricing has been granted that may be rescinded upon the occurrence and during the continuation of a default
4. Limitations or caps on guarantees may be reduced or eliminated as a result of a default
5. All proper landlord, bailee, and mortgagee waivers and agreements have been obtained
6. Payments have been made to the borrower that may be deemed a preference if bankruptcy is filed in the near future
7. The borrower's business insurance is in force and appropriate endorsements, such as lender loss payable, have been obtained
8. Account debtor notification letters (blank) have been signed

After completing the file review, the attorney should make appropriate recommendations to the lender and assist in implementing them. These may include:

1. Perfecting the lender's security interest, if necessary
2. Sending default letters, if not previously done
3. Identifying parties who must receive notice and the proper method for sending such notices, or ensuring that all notices sent previously met the requirements of the loan documents
4. Increasing the interest rate to the default rate of interest
5. Gaining control of the borrower's cash, either through a "springing" right under the existing loan documents or through an amendment to them, perhaps in connection with a forbearance agreement
6. Implementing additional borrowing reserves or availability blocks
7. Recommending that the lender be less or more aggressive, depending on the expected impact of a bankruptcy filing on the borrower
8. Identifying any additional collateral of the borrower, guarantors, principals, or other obligors in which the lender could obtain a perfected security interest

In a turnaround, the borrower will provide a budget to the lender, if it has not done so earlier. The budget is a critical factor in helping the lender form an opinion on the borrower's viability as a going concern and the associated risks. This, in turn, helps the lender decide whether it makes good business sense to fund the borrower going forward and if so, how much capital to commit. In connection with these decisions, the lender's counsel can play a valuable role by providing a critical review of the budget as a whole and making sure that all legally required items, such as sales taxes, withholding taxes, and other taxes, are included.

One of the more important issues in a turnaround is the lender's level of trust in the integrity and competency of the borrower's management team. In a liquidation, for instance, this may determine whether the lender forecloses and sells the borrower's assets or allows the borrower to liquidate its assets itself. This is generally the preferred course of action, as long as the borrower's senior management is trustworthy and the task is not beyond its capabilities.

Unless it is fully comfortable with the borrower's management team, the lender frequently determines that a crisis-management specialist is required to ensure that the borrower's business is run satisfactorily and that budgets and reports are completed properly. If that is the case, the lender's counsel can recommend two or three specialists in whom the attorney has an overall level of confidence and who may also have expertise in the borrower's line of business, whether that be retail, wholesale, lumber, maritime, or another field.

Although the lender can perhaps contractually obligate the borrower to retain a crisis-management specialist—by agreeing to forbear against the borrower's collateral, for example—the ultimate decision on which specialist to hire from the recommended list should be the borrower's. This is important because it helps to insulate the lender from potential "control" and other lender-liability claims by the borrower.

Protecting the Flanks

When a bankruptcy is filed, either through a voluntary petition by the borrower (now called a "debtor") or an involuntary petition by a group of creditors, lender's counsel must focus on other issues that then come into play.

Initially, the attorney must be fully versed on the local rules in the jurisdiction of the bankruptcy filing. Depending on the jurisdiction, local counsel may be required. Local rules, customs, and even guidelines can provide practical insight into the manner in which the bankruptcy proceeding will be conducted. In some cases, local rules may even provide an unpleasant surprise or two.

For example, local bankruptcy rules in New Hampshire dictate that a debtor has virtually automatic use of its cash collateral for as long as 30 days after a petition is filed. This is in stark contrast to the procedures in almost every other jurisdiction and is seemingly inconsistent with provisions of the Bankruptcy Code.

If the debtor informs the lender of its intention to file bankruptcy, lender's counsel will have anywhere from a couple of days to a week or two before a petition is filed to arrange for an acceptable cash collateral order. Among other things, such an order:

1. Authorizes the debtor to obtain post-petition financing from the lender, assuming the lender wants to provide debtor-in-possession (DIP) financing
2. Provides adequate protection to the lender by granting a first-priority security interest in and a replacement lien on all of the debtor's assets
3. Modifies the automatic stay to allow for collections
4. Incorporates modifications to the loan documents that have been mutually agreed upon by the debtor and the lender

The modification agreement authorized by such an order provides the lender with the opportunity to fix any remaining problems in the credit that were identified through counsel's legal review. Other typical modifications include:

1. Increasing the interest rate, facility fees, or collateral-monitoring fees to compensate the lender for staying in the credit and for assuming the increased credit risk
2. Additional or more-frequent reporting requirements in connection with the debtor's collateral
3. Reducing the term of the credit
4. Adding specific events of default arising out of the bankruptcy, including any modification to any financing order without the prior written consent of the lender, conversion of a debtor's Chapter 11 to a Chapter 7 case, the appointment of a trustee, and the filing of a plan of reorganization that does not provide for full payment of the obligations owed to the lender

If the debtor does not inform the lender of its intention to file bankruptcy or if an involuntary petition is filed, the parties will be forced to scramble to negotiate an acceptable cash collateral order. This order will be a scaled-back version of the order discussed earlier and is intended simply to get the debtor through an initial period of time and provide adequate protection to the lender.

Typically, the lender will permit the debtor to borrow a sum of money established in a negotiated budget. Then, the lender's counsel will work with the debtor to obtain more-permanent financing, which may require several short-term interim orders before a more all-inclusive cash collateral order can be issued.

Summary

Lender's counsel can provide invaluable services in a turnaround. With the proper attitude, creativity, communication, and due diligence, lender's counsel can help make sure that, at the end of the day, the lender's "fort" is still standing tall.

Michael P. Bonner is a partner in Stradley, Ronon, Stevens & Young, LLP's finance and reorganization practice group. He can be reached at (215) 564-8158 or at mbonner@stradley.com.