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Regulatory Update: The Successful Work-Out

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By Cherie S. Raidy

Business as usual now includes, for most lenders, dealing with problem loans, defaults and covenant violations, loan modifications, and forbearance agreements, in addition to new loans.

ELEMENTS OF A SUCCESSFUL WORK-OUT

The successful work-out involves one part psychology, one part working together to resolve the problem issues, and reaching a result that may not be completely comfortable for the lender or the borrower. The successful work-out most commonly revolves around collateral that still has value, a borrower with a good business that is down, or guarantors with the wherewithal to invest in the business or see it through the difficult times. The successful work-out often involves a factual pattern in which the lender will not be better off by foreclosing, and the borrower will do much better as well if the borrower can salvage the business, cut costs, and weather the storm. The lender's collateral for the loan may have lost value in the recession, making foreclosure a last choice remedy.

Alternatively, the borrower will have difficulty refinancing with another new lender with collateral that is valued at a lesser value than at the pre-recession loan origination with the present lender. For better or worse, the lender and the borrower will do best under these scenarios if they can work together toward an achievable result. Each loan and borrower is different, and what worked well with one borrower may not work with another. Also, there are those occasions when a work-out is not possible due to lack of collateral, failure of the business, etc., which are not the topic of this column.

Many borrowers seek to obtain leverage against the lender by threatening to sue the lender under various theories, such as lender liability. They allege that the reason they are in default was because of the lender's respective actions: not lending additional funds, not renewing the loan, transferring them to special assets—to name a few.

The psychology of these allegations initially causes the lender to reconsider whether they want to continue with the borrower. At this point, a new low in their relationship has been reached, and counsel often is retained on both sides. The willingness to resolve the issues by both counsel and the parties will be required in order to move forward. This often takes time and a cool review of the situation, the facts, and the value of the collateral.

Normally, if they work toward a reasonable result, the next step will be a forbearance agreement with a release of claims, with the borrower required to meet various performance obligations during forbearance. Interest on the loan may be waived during the specified forbearance period. Each forbearance agreement must be tailored to the borrower, the collateral, and thought given to how the desired result of the work-out may be obtained over a period of time set forth in the agreement. Lenders sometimes prefer forbearance to loan modification because the forbearance agreement stays the default during the agreement, whereas a loan modification will cure the default and rewrite the loan. Whether the lender and borrower decide to proceed with a loan modification or a forbearance agreement will depend on the loan, the facts, the collateral, and many other considerations.

SPECIAL RULES IN CALIFORNIA

In seeking to enforce remedies against a defaulted borrower in California, careful attention must be given to the one action rule, the anti-deficiency statutes, and seeking to enforce remedies in a manner that is not consistent with California's protective laws. The one action rule [Section 726a of the California Code of Civil Procedure] has several aspects:

1. The security first rule, meaning the lender must proceed against its security and not ignore the collateral while suing on the note;
2. The single action rule requiring the lender to enforce its security in one action; and
3. Judicial foreclosure is the action in which a lender may enforce its security (a non-judicial foreclosure is not an action).

Particularly for out of state lenders, the exercise of its rights by a banker's lien with set-off against an unpledged bank account will violate the security first rule, a danger for lenders accustomed to this remedy outside California. Please note that exercise of the lender's rights under Section 2938 of the CA Civil Code through appointment of a receiver and collection of rents does not violate the one action rule as set forth in the statute. Examples of one action rule violations include proceeding against the note to judgment without foreclosing on the security, set-off against a bank account through a banker's lien or other unpledged assets, and multiple actions against the collateral after judicial foreclosure. The case law and statutes, while simple at first read, can become very complicated in application, and therefore consideration should be given to seek advice of counsel.

Another interesting issue that may arise is the sham guaranty. If the guarantor is really the debtor, and the debtor is already obligated on the debt, the addition of a guarantee from, in essence, the debtor is referred to as a sham guaranty. If the guarantor is the alter ego of the borrower, or is already subject to liability on the debt, the court may find a sham guaranty exists, and the guaranty will be unenforceable. The courts will look behind the guaranty to determine if an attempt has been made to prevent the protections of and application of the anti-deficiency laws.

California Civil Code Section 2856 allows the guarantor to waive certain surety ship defenses, and contains model waiver language for lenders to include in a guaranty. Therefore, it is important to check the guarantees for these waivers; otherwise, surety ship defenses will apply. Inclusion of the waivers is very beneficial to the lender because it allows the lender to sue the guarantor first for the outstanding debt prior to seeking foreclosure of the debtor's collateral; and foreclose the property non-judicially or judicially and afterwards collect the difference between the debt and the sale price of the collateral, to the extent there is a deficiency. The lender and guarantor will each respectively review the guarantee for these provisions once a default of the loan has occurred.

SUMMARY

In retrospect, there are many reasons for the lender and borrower to desire a work-out over otherwise draconian remedies, particularly when the fall in collateral value or the borrower's business may be temporary or solvable over a period of time. The forbearance agreement can help relieve stress on the borrower to meet unreachable covenants during the forbearance period until the stress has been resolved. The lender can maintain a borrower that but for the current problem, may be a good relationship that is salvageable. Additional time may allow the borrower to return to profitability, and the collateral to ascend in value. Therefore, working together, while at times difficult, may be the best remedy for both lender and borrower.