abfjournal
Reprinted from the July/August 2004 Issue, Vol. 2, No. 7

Have No Fear...

A Borrower's Bankruptcy Is Not the End of the World Part I — Preparation

With proper planning from the inception of the relationship and appropriate vigilance, an asset-based lender need not fear a borrower's bankruptcy. Rather than viewing it as the end of the world, the lender should instead concentrate on obtaining the benefits that bankruptcy might offer.

By Trent L. Rosenthal

EDITOR'S NOTE:
Part I of this Article will discuss planning for a borrower's bankruptcy. Part II, to be published September issue of *ABF Journal*, will discuss the effects of a borrower's bankruptcy as well as identify appropriate action steps for an asset-based lender to take if a borrower files bankruptcy.

The thought of a debtor's bankruptcy strikes fear in the heart of some asset-based lenders, while other lenders express no fear at all. As one factoring company representative recently commented: "If the factor has done his job correctly in terms of evaluating the risk and negotiating the deal, and the factor's counsel has done his job in terms of proper documentation and advice, there should be no concern about the effect of a bankruptcy filing." This professional's strategy was to do everything possible to discourage a bankruptcy filing by tying up the borrower's assets and making the bankruptcy process an expensive tool without any corresponding benefit.

In a vacuum, the representative's analysis might be sound, but it overlooks the fact that other parties often stand to benefit from a bankruptcy filing, including the debtor's management, unsecured creditors, and, perhaps even its shareholders. For this reason, a creditor must take into account the possibility that a debtor will actually file bankruptcy.

Nevertheless, with proper planning from the inception of the relationship and appropriate vigilance, an asset-based lender need not fear a borrower's bankruptcy. Rather than viewing it as the end of the world, the lender should instead concentrate on obtaining the benefits that bankruptcy might offer.

Plan for a Filing

Even if the borrower is financially sound, the asset-based lender should develop a bankruptcy exit strategy at the inception of the relationship. That might sound paranoid, but an asset-based lender that prepares, embraces the debtor's bankruptcy and aggressively pursues collection through the bankruptcy process, will maximize its recovery. An asset-based lender might fare even better in the bankruptcy context than otherwise.

The lender should hire competent counsel familiar with bankruptcy law issues, and the law firm should do more than simply draft loan documents. The firm should have bankruptcy counsel available to provide input on an ongoing basis and be in a position to add value to the transaction by helping the asset-based lender identify ways to reduce the risk of bankruptcy.

Use Iron Clad Documents

Obviously, transactions should be structured using comprehensive, up-to-date documentation. The law changes frequently, and boilerplate provisions often need to be re-worked. The documents can strongly favor the asset-based lender and should have every conceivable protection and remedy. After all, the asset-based lender's greatest leverage usually, but not always, exists when the borrower needs the money. When negotiating the terms, the lender should not agree to any concessions or revisions to the documents that would make it unreasonably more difficult for the lender to exercise its remedies.

Manage the Risk of a Borrower's Bankruptcy

Lenders often feel the balance of power shifts toward the borrower once bankruptcy is threatened. As a result, lenders sometimes grant unwarranted concessions to the borrower. Bankruptcy, however, should be viewed as any other risk that can be effectively managed throughout the relationship. With proper preparation, the asset-based lender can price the deal accordingly and without too much concern about a possible bankruptcy. Because an asset-based lender makes loans based on the underlying collateral's value and is not necessarily relying on the debtor's financial condition for repayment of the loan, the asset-based lender should focus first and foremost on protecting its interest in the collateral.

Bankruptcy Code Priority Scheme

Under the payment scheme mandated by title 11 of the United States Code, commonly referred to as the Bankruptcy Code, secured creditors fare much better in a bankruptcy case than unsecured creditors, such as trade creditors. Creditors holding a security interest in the debtor's property are at the top of the list for payment. If the value of the secured creditor's collateral is sufficient to pay the claim in full, the secured creditor, with certain exceptions, is entitled to be paid in full — even before payment of administrative expenses. Some bankruptcy cases involve a consensual "carve-out" from the secured creditors' liens to cover professional's fees and expenses, which elevates the claims for professional fees above the secured parties' claims, however an asset-based lender should carefully evaluate its collateral position before agreeing to a "carve-out." Under the bankruptcy payment scheme, the claims immediately below secured claims are commonly referred to as "priority claims" and include such claims as individual wages, employee benefit plans and taxes. Finally, at the end of the line, are general unsecured creditors and equity holders. In order to preserve its position at the top of the payment list, an asset-based lender

must ensure it is properly secured through perfected and enforceable liens and security interests in the collateral.

Collateral is King

Lenders should take collateral not only for its value, but also for purposes of strategic advantage and control. Subject to competitive market conditions, a lender will be well served by obtaining a security interest in more than just the assets subject to the transaction. A lender entering into a traditional accounts receivable facility that also obtains blanket liens on general intangibles or equipment will have to be dealt with if the business is sold. Even if the collateral, such as used equipment, has little or no value at the time it is pledged, such collateral could prove critical to the lender's success in the bankruptcy context.

The factoring process also can provide significant insulation from bankruptcy. By factoring, a borrower/customer sells its accounts to a factoring company. This can, if structured correctly, remove those assets from property of the bankruptcy estate prior to any bankruptcy being filed.

Obtain Adequate Collateral Before Bankruptcy

Prior to bankruptcy, lenders should frequently review their collateral and shore up their position. At a minimum, the lender should confirm that it has a valid and perfected lien on sufficient collateral to cover the debt. If a default is imminent, a lender might seek additional collateral in exchange for an agreement to forbear from exercising its rights as to the primary collateral. The lender can use a default as an opportunity to require a borrower to correct any deficiencies as part of any forbearance agreement.

Of course, payments or other rights obtained from a debtor shortly before bankruptcy could be subject to attack under certain provisions of the Bankruptcy Code. Therefore, it is preferable to create collateral liens at the inception of the transaction. Nevertheless, it is better to have a lien subject to being set aside than no lien at all.

Hire a Turnaround Professional to Help Evaluate the Alternatives

Immediately after a problem becomes apparent, the lender should engage a professional familiar with bankruptcy issues and with maximizing recovery for secured creditors. Numerous professionals have specific expertise in counseling lenders on how to deal with these situations, and collateral monitors, field monitors and appraisers can also add value. The lender should interview several candidates, check references and experience, and make sure that the firm hired has expertise in the industry. The asset-based lender might be able to shift the costs of these professionals to the borrower as a cost of collection.

Recognize That Bankruptcy Can Be Beneficial

Bankruptcies sometimes benefit asset-based lenders. Outside of bankruptcy, creditors' state law remedies are often slow and cumbersome, whereas the bankruptcy system is designed to be efficient and orderly. Also, outside bankruptcy, the debtor might use proceeds of the lender's collateral to pay other junior debts (such as unsecured trade debt). The bankruptcy process, however, ensures significant control over the debtor's funds. The debtor in possession or trustee must make periodic reports to the court and cannot freely dispose of assets. Notably, the bankruptcy laws are designed to deal with both honest and dishonest debtors in financial distress.

Although it is a rare occurrence, an asset-based lender might desire to put the debtor in bankruptcy by way of an involuntary petition. Doing so probably would require other unsecured creditors to join in the petition. Given the penalties and costs associated with filing an "improper" involuntary case, a lender should evaluate this course of action thoroughly. The lender might instead elect to aggressively pursue its contract and state law rights, which sometimes force a bankruptcy filing. Posting collateral for foreclosure, for example, can leave the debtor with few options, such as (i) reaching a deal with the lender, (ii) allowing the foreclosure, or (iii) filing bankruptcy.

Develop and Implement an Action Plan

When facing a borrower bankruptcy, the asset-based lender and its counsel should develop and implement a written action plan based on a combined legal and business point of view. Key questions to consider in connection with designing a strategy include:

- Is there immediate danger brought on by fraud or dissipating collateral?
- Is the borrower being cooperative or disruptive?
- Can the lender improve its collateral position?
- Are there any advantages from forbearance of the asset-based lenders' rights?
- Are the documents complete and has the lien been properly perfected?
- What is the value of the collateral if the debtor is liquidated rather than operating as a going concern?
- What actions could other creditors take and how will those actions affect the lender?
- Are there other collection opportunities against guarantors or third parties?
- Is the lender better off if the borrower is in bankruptcy?

Planning for the bankruptcy and developing a strategy based on the answers to these key questions should yield a more favorable and productive outcome.

Part II of this article will discuss what an asset-based lender can expect once the bankruptcy is filed and provide some advice as to how to best protect itself. The recent Supreme Court decision, *Till vs. SCS Credit Corp.*, — U.S. — (2004), 124 S. Ct. 1951 (2004), Slip Opinion No. 02-1016 (May 17, 2004), will be discussed, which addresses the issue of the interest rate that should be paid to a secured lender if the debt is restructured in a bankruptcy. Part II will also discuss a recent case involving a factoring company that was held in contempt for violating the stay when it was overzealous in its collection efforts during a Chapter 11 case. abfj

Trent L. Rosenthal *is a shareholder in the Litigation and Bankruptcy Group of the Houston law firm of Boyar & Miller. He is board certified in business bankruptcy law by the Texas Board of Legal Specialization. Rosenthal has devoted a substantial portion of his practice to representing asset-based lenders, including factoring companies, in connection with out of court workouts, Chapter 11 reorganizations, bankruptcy and related litigation matters.* *The writer acknowledges* **Todd Zucker**, *of Boyar & Miller, for his editorial comments and review of this article.* *Rosenthal may be reached at (713) 850-7766, and by email at trosenthal@boyarmiller.com.*

Houston Business Journal - March 31, 2003
http://houston.bizjournals.com/houston/stories/2003/03/31/focus8.html

HOUSTON BUSINESS JOURNAL

BUSINESS PULSE SURVEY: What will be the final score for the new, improved Texans at th

Consider option of work-outs when tenant has money woes

Houston Business Journal - March 28, 2003 by Trent L. Rosenthal Special To Houston Business Journal

Even after careful planning, design and construction of leasehold projects, tenants all too often suffer financial difficulties and find themselves unable to meet their obligations to the landlord.

The financial impact on the landlord may hinge upon the landlord and tenant being able to reach an amicable "work-out," in which the parties agree to terms and accommodations different from those specified in the lease agreement. If a work-out cannot be achieved informally, the tenant might be forced to seek protection under the Bankruptcy Code.

By understanding the work-out process and remaining aware of the tenant's options, a landlord will be better positioned to negotiate an agreement it can live with and that will permit the tenant to remain viable.

Groundwork

The work-out process usually begins by a phone call or letter from the tenant asking the landlord to grant certain rent relief, such as forgiveness or abatement of rent due under the lease. In some situations, a tenant may ask for other concessions, such as a reduction in space, a release from obligations under the lease or relief from other non-monetary obligations.

In communications with the landlord, the tenant should be open and realistic.

A landlord should ask the tenant to make a written proposal as to how it plans to work out the problems, including cash flow statements and other relevant financial information.

Establishing a baseline

At this point, a wise landlord will promptly engage counsel experienced in tenant defaults, work-outs and bankruptcy matters to counsel it through the work-out process.

The landlord should request a negotiation agreement which provides that the parties will negotiate toward a resolution but that nothing will be binding unless a written document is signed and approved by both parties. Such an agreement will prevent either party from later claiming a deal based on oral discussions during the work-out process.

The landlord should design a comprehensive approach for dealing with the situation and establish its own objectives, such as regaining possession of the space, recovering damages from the tenant or a combination of both. First and foremost, counsel for the landlord should review all of the lease documents.

These documents establish a baseline for landlord remedies.

To gain leverage in the work-out process and negotiate from a position of strength, a landlord may want to promptly exercise all of its available remedies under the lease, such as lease termination.

All contents of this site © American City Business Journals Inc. All rights reserved.

A terminated lease might not become a part of the tenant's bankruptcy estate, and in some situations, the landlord can gain significant protection by terminating. On the other hand, a tenant who desires to protect a valuable leasehold might be advised to seek bankruptcy protection prior to lease termination.

The landlord must understand which rights will survive/exist in bankruptcy. A landlord also should keep in mind that a tenant bankruptcy might not be a bad alternative. The tenant will be granted a reprieve from paying its pre-filing date trade creditors, which should make more cash available for the creditors essential to its business, such as the landlord. Also, the tenant will be required to timely perform its obligations under the lease after the date of the bankruptcy filing, including the obligation to pay rent.

In a bankruptcy, the tenant has essentially three options:

• The tenant can reject the lease and surrender the premises to the landlord. If this happens, the landlord will have a damage claim against the tenant; however, such a claim is generally limited under the bankruptcy laws to approximately one year's rent plus the back rent that was owed. The value of such a claim is uncertain. In larger cases, some distribution to unsecured creditors usually occurs, although it frequently amounts to pennies on the dollar amount of the claim.

• The tenant also has the option of assuming the lease, curing all defaults and providing adequate assurance of future performance. If this option is selected, the landlord benefits by recovering everything owed and at the same time maintaining the tenant.

• The tenant's third option is to assume the lease and assign it to a third party with approval of the bankruptcy court. The tenant often will try to extract value from the lease through an assignment. However, use restrictions in the lease will remain applicable, and the tenant might have difficulty finding an appropriate assignee.

If the landlord decides to attempt a work-out and avoid a bankruptcy, the tenant and landlord should evaluate such options as rent deferral, rent abatement and reduction in space.

In case of rent deferral or abatement, the landlord should negotiate an agreement that remains in effect if certain conditions are met, such as no defaults occurring under the lease. A landlord might also demand that the tenant reduce its space or vacate completely. If the market rent exceeds the amount specified in the lease, the landlord might actually benefit from reletting the space. An agreed lease termination or buyout of the lease also can provide a workable solution for the landlord who desires to avoid being dragged into a tenant bankruptcy.

Work-outs can be a win-win situation for both the landlord and the tenant. If the process fails, the landlord and the tenant should remain prepared to meet each other in bankruptcy court.

Trent L. Rosenthal is a shareholder in the bankruptcy and litigation section of Boyar & Miller P.C.

Contact the Editor | Need Assistance? | More Latest News →

abfjournal

Reprinted from the September 2004 Issue, Vol. 2, No. 8

Have No Fear...

A Borrower's Bankruptcy Is Not the End of the World Part II — Effects & Appropriate Actions

With proper planning from the inception of the relationship and appropriate vigilance, an asset-based lender need not fear a borrower's bankruptcy. Rather than viewing it as the end of the world, the lender should instead concentrate on obtaining the benefits that bankruptcy might offer.

By Trent L. Rosenthal

EDITOR'S NOTE:
Part II of this article discusses the effects of a borrower's bankruptcy as well as identifies appropriate action steps for an asset-based lender to take when a borrower files bankruptcy. Part I, published July/August issue of *ABF Journal*, discussed planning for a borrower's bankruptcy.

An asset-based lender receives notice that despite efforts to work with a borrower to avoid bankruptcy, the borrower has filed a Chapter 11 reorganization case. The press release states the borrower seeks to restructure its balance sheet. Translation: Delay and hassle for the asset-based lender. The lender's claims are one of many obligations the debtor will attempt to restructure. This time, however, the lender has nothing to fear. As discussed in Part I of this article, the lender planned for the bankruptcy, developed a strategy and will use the process to maximize its recovery.

This article discusses what lenders can expect in a bankruptcy and identifies steps lenders should take, including seizing upon such opportunities as offering profitable debtor-in-possession or exit financing.

Hire Bankruptcy Counsel

The well-prepared lender normally will have hired bankruptcy counsel well in advance of the bankruptcy, but if not, now is the time to do so. Because the borrower often can choose between several jurisdictions, such as the borrower's principal place of business or the location of its principal assets, it often is difficult to determine in advance where the case will be filed. Nevertheless, it makes sense for the lender to line up local counsel in jurisdictions where the filing might occur so that the lender will be ready. The lender also should maintain an ongoing relationship with primary bankruptcy counsel familiar with the lender's practices and who is committed to producing value for the lender. Primary counsel can work with and help select local counsel.

First Day Pleadings in Chapter 11 Cases

Concurrently with its Chapter 11 filing, the borrower usually files motions commonly called "first day" pleadings. These include professional retention applications, procedural pleadings, and motions to use cash collateral and to approve the debtor's borrowing under a debtor-in-possession lending facility. The lender must react quickly. The relief granted on the first day of the case can set the course of the entire proceedings. The lender should pay close attention to cash collateral and borrowing motions and confirm that its liens and priorities are preserved. For example, the lender will need to obtain replacement liens on post-petition assets to the extent the debtor uses any cash collateral. The lender also should insure the borrower is not granting liens with priority over or equal to the lender's lien, unless the lender determines such liens are in its best interests and consents.

DIP Financing

To finance the reorganization, the debtor likely will need debtor-in-possession financing. With its considerable information concerning the debtor's financial condition, the pre-filing date asset-based lender is in an excellent position to offer such financing and should be able to make a quick underwriting decision. Post-petition financing arrangements offer many benefits, including:

Confirmation of Liens and Releases

As part of any debtor-in-possession financing, the lender should require the debtor to confirm the validity, extent and priority of the lender's pre-petition claim and lien and should seek a release of claims by the debtor. Courts have approved such releases if convinced the debtor would be unable to reorganize without the loan and that the release is appropriate under the circumstances — particularly where the debtor has had an opportunity to investigate such claims. The court can approve the lien confirmation and release in the order approving the financing. Bankruptcy courts usually order an investigation period (i.e. 60 days after entry of the order) during which other parties may challenge the lender's claim and lien. However, most courts allow the debtor to agree not to contest the lender's claims and liens as a requirement of the post-petition credit facility. Once the investigation period concludes, the lender's position is enhanced.

Cross-Collateralization

Lenders providing post-petition facilities can seek not only liens on post-petition assets to secure debtor-in-possession financing facilities, but also liens on pre-petition collateral. Lenders also can demand liens on post-petition collateral to secure pre-petition debt. Cross-collateralization is sometimes difficult to obtain, but it has been approved in some circumstances. Cross-collateralization can substantially improve a lender's position if the pre-petition collateral does not have sufficient value to cover the lender's claims.

Timeline for Chapter 11

Lenders can establish timelines and milestones for the debtor to take certain actions, facilitating a quick emergence from Chapter 11.

Avoid Dealing with a New Lender

By agreeing to extend the post-petition facility, lenders can avoid having to deal with a new lender and related lien-priority issues, such as the debtor's efforts to subordinate the current lender's liens.

Earn Fees

Last, but not least, lenders can earn higher fees and interest typically associated with a debtor-in-possession facility. The market of willing debtor-in-possession lenders is expansive because of the tremendous opportunity that can be obtained from this lending. It can be profitable, and the risk can be managed with court-approved protections.

Automatic Stay Issues

Upon the bankruptcy filing, the lender is automatically stayed (prohibited) under section 362 of the Bankruptcy Code from taking collection actions against the borrower or collateral. In other words, a lender cannot exercise rights or remedies set forth in the loan documents, such as foreclosure against the collateral, unless the bankruptcy court "lifts," or removes, the stay and allows the lender to proceed. Because damages can be assessed for violations of the stay, lenders should err on the side of caution. For example, an account receivable factor should consider holding in reserve collections from factored accounts and non-factored accounts and seek relief from the stay on grounds that the factored receivables belong to the factor and are not "property of the estate." The factor also should seek permission to collect non-factored accounts, which are usually pledged to secure obligations owing to the factor.

The serious consequences associated with violating the stay are illustrated by a recent case, *All Trac Transp., Inc. v. Transp. Alliance Bank*, Adversary No. 02-3390, (*In re All Trac Transportation, Inc.*), Main Case No. 02-37005 (N.D.TX-Dallas Division, February 17, 2004 and June 7, 2004).

In *All Trac*, the customer sued a factor seeking damages for the stay violations and sought to hold the factor in contempt for violating court orders. The court found that the factor had violated the stay by subtracting money from the debtor's reserve account and applying such monies to the obligations of the debtor, sending a letter to the customers of the debtor instructing them to remit payment directly to the factor and transferring funds from the debtor's accounts. The debtor blamed the failure of its business on the factor's conduct and asked the court to award substantial damages, including lost profits. The court might have awarded such damages had there been adequate proof, but the court only awarded a small amount of compensable damages. The court also awarded some, but not all, of the fees incurred by the debtor in connection with the matter (approximately $68,000 out of the $450,000 requested by the debtor). If the debtor's actual fees were $450,000, the factor's defense costs presumably were substantial and could have been avoided had the lender sought and obtained relief from the stay before it took action.

In light of the risks, lenders should file early motions for relief from the stay and proceed cautiously once a client files a bankruptcy case. A lender may also seek adequate protection for the use of the collateral. Available forms of adequate protection include periodic payments to the lender, replacement liens on post-petition collateral, and a requirement that the debtor maintain insurance, among other things.

Proofs of Claim

The lender should be prepared to file a proof of claim evidencing the balance due on or before the deadline. Failure to timely file a claim can result in the claim not being entitled to receive any distribution in the case. On the other hand, the act of filing a claim can waive the lender's right to a jury trial on certain issues. Therefore, the lender and its counsel should carefully consider these issues in advance.

Monitor the Case

Even court filings that appear routine can significantly impact the prepetition lender. Therefore, the lender must actively monitor the case. For example, one of the first pleadings typically filed is the debtor's request to use cash collateral, which typically includes accounts receivable pledged to the lender. Failure to properly protect the lender's claim at this point in the case can lead to catastrophic consequences.

Sale of Assets

If the borrower seeks to sell assets free and clear of liens, claims and encumbrances, the lender should ensure that its lien on proceeds is preserved and that such proceeds will be paid to the lender in exchange for a release of lien. The lender can withhold its consent to a sale or use its claim to credit bid on the assets — similar to a credit bid at a foreclosure — if the lender opposed the sale or desires to acquire the collateral.

Confirmation Matters and Interest Rate

The lender should carefully evaluate the treatment of its claim under the debtor's plan of reorganization, including the proposed interest rate. In a recent case, *Till v. SCS Credit Corp.*, 124 S. Ct. 1951 (2004), the Supreme Court concluded that the prime plus or formula rate was the appropriate rate of interest to use for a secured claim restructured in a Chapter 13 bankruptcy. Although the *Till* case involved an automobile in a Chapter 13 case, the decision may have far-reaching consequences. A secured creditor is entitled to an interest rate for its restructured secured claim to be determined by the formula or risk adjusted rate. Courts will determine what a normal commercial bank would charge to a credit-worthy commercial borrower to compensate for the lost opportunity cost, inflation risk and relatively slight default risk, and adjust the rate to take into account the greater non-payment risk bankrupt debtors typically pose.

The court in *Till* noted the existence of a free market for lenders advertising financing for Chapter 11 debtors-in-possession, as opposed to a market for willing cram-down lenders. Accordingly, when picking a cram-down rate in a Chapter 11 case, the appropriate rate might be the rate an efficient market would produce. See *Till*, n.14. A secured lender involved in a cram-down situation might argue it should receive an even higher rate of interest on its secured claim than it had contracted for. With secured lenders seeking higher interest rates and borrowers requesting lower rates, the resulting compromise might be somewhere between the original contract rate and the default rate.

Conclusion

Bankruptcy clearly changes the playing field. Lenders that remain diligent and understand the process can maximize recovery. A lender should not fear a borrower bankruptcy, but should recognize the benefits bankruptcy might actually offer. The next time the lender receives the call about a bankruptcy filing, the lender's response can be: "Great, we were hoping you would file soon." **abfj**

Trent L. Rosenthal *is a shareholder in the Litigation and Bankruptcy Group of the Houston law firm of Boyar & Miller. He is board certified in business bankruptcy law by the Texas Board of Legal Specialization. Rosenthal has devoted a substantial portion of his practice to representing asset-based lenders, including factoring companies, in connection with out of court workouts, Chapter 11 reorganizations, bankruptcy and related litigation matters.* *The writer acknowledges* **Todd Zucker**, *of Boyar & Miller, for his editorial comments and review of this article.* *Rosenthal may be reached at (713) 850-7766, and by email at trosenthal@boyarmiller.com.*