Distressed Debt and Workout Agreements During the COVID-19 Pandemic

By: Nancy Sabol Frantz, Steven Ostrow and Andrew Marrinucci
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Creditors facing a cascade of distressed credit facilities resulting from the economic fall-out from the COVID-19 pandemic will need experienced counsel at all stages of workouts, from preliminary discussions through the negotiation and preparation of loan amendments or forbearance agreements. Businesses throughout the country in most industries have been adversely impacted by the outbreak of COVID-19, whether due to government ordered closures, mandatory and voluntary quarantines, social distancing, workforce reductions, supply-chain shortages or other issues. Governmental restrictions exempting even so-called "essential" or "life-sustaining" businesses can have negative impacts as the definition of such businesses vary by state.

As a result, commercial borrowers are already, or will shortly be, defaulting on debt service payments and loan covenants. Borrowers are requesting payment delays, waivers and forbearances from their lenders during this difficult period. One of the primary issues that both sides must address is the uncertainty surrounding the duration and severity of the COVID-19 pandemic and its effect on the borrower's business in the future. To evaluate appropriate workout options and protect their position, creditors should undertake the following best practices:

- Obtain the borrower's current financial and operational information to review its overall financial condition, ascertain the extent of the material adverse change in circumstances caused by the pandemic, and assess its plan, capability and timing to resume normal operations, including restoring its critical business relationships and improving its cash flow.
- Consider issuing appropriate default notices to trigger applicable cure periods and provide the lender the opportunity to exercise remedies, if necessary to protect and preserve its collateral or other rights. Even during good economic times, default notices must be carefully drafted to preserve rights and avoid subsequent challenges.
- At the early stage of workout discussions, enter into a pre-negotiation agreement (PNA) with the borrower and any guarantors, as outlined in our firm's previous article about PNAs. The PNA offers significant protection to creditors against potential lender liability and other claims of a borrower or guarantor by providing, for example, that: all communications during the workout are considered settlement discussions and inadmissible in litigation; the lender may, in its sole discretion and at any time, enforce its rights during discussions or terminate negotiations without cause; and no statements, commitments, agreements, drafts or discussions between the parties are legally binding unless and until memorialized in a definitive written agreement executed by all parties.

If the parties can establish a preliminary plan to "workout" the defaults and relief requested by a borrower, the terms of any loan amendment or forbearance agreement should be both thorough and practically achievable, and carefully prepared by legal counsel. In our experience representing secured creditors during several economic downturns over the past thirty years, we consider the following terms critical for any workout agreement:

- **Defaults** – list all known defaults and obtain borrower and guarantor acknowledgements of the defaults and the indebtedness.
- **Payments** – monthly debt service or maturity payments, if postponed, should be extended in the short-term with appropriate triggers for acceleration of payments upon subsequent defaults and other customary adverse events.
- **Credit Lines** – lines of credit may need to be limited temporarily based on the borrower's situation.

- **Term** – establish a reasonable term for the amendments or forbearance with practical benchmarks for extensions and clear, comprehensive conditions for termination. Given the uncertainty surrounding the pandemic and forecasts of when the outbreak "curve will flatten," only short-term arrangements should be entered into by the parties at this time.
- **Collateral** – confirm the validity, enforceability and priority of all liens and security interests against a borrower's and/or a guarantor's assets, and obtain and perfect interests in any additional collateral for the loan.
- **Covenants** – adjust or suspend certain loan covenants, as circumstances require, again on a short-term basis.
- **Escrows** – place deeds, bills of sale, assignments and other documents transferring collateral or other assets into escrow.
- **Taxes** – thoroughly analyze tax consequences for all parties, especially cancellation of debt tax, realty transfer tax and pending legislation.
- **Reporting** – establish more frequent and detailed financial and other reporting.
- **Release** – ensure that all debtors and guarantors release the creditor from all liabilities.
- **Automatic Stay** – if possible, include consent by the borrower and all guarantors for the creditor to obtain relief from the automatic bankruptcy stay (these consents are enforceable to varying degrees in many jurisdictions).
- **Preserve Remedies** – ensure that all rights and remedies of the creditor are preserved and that by entering into the workout agreement, you do not misstep and lose a remedy. For example, in Pennsylvania, a court recently held that a creditor lost its right to confess judgment because the warrant of the attorney granting such remedy was not restated in the parties' forbearance agreement. *CEBV, LLC v. Schwartz*, 2019 Phila. Ct. Com. Pl. (Pa. C.P. January 8, 2019)

For most distressed credit facilities caused, directly or indirectly, by the COVID-19 pandemic, a workout agreement is the most suitable arrangement for resolving short-term credit issues, maintaining a good lender-borrower relationship, avoiding a premature foreclosure or termination of a line of credit, and adjusting the parties' rights and obligations while the country awaits the containment of the outbreak and ensuing economic recovery.

On March 27, the FDIC issued a series of answers to FAQ's for financial institutions with respect to loan modifications in light of COVID 19. Of most importance is that loan modifications due to COVID 19 do not need to be classified as Troubled Debt Restructurings (TDR's), and do not need to be reported as past due. The FAQ's include other important guidance on appraisals, such as the ability to make an assumption about the interior of a property if it is unsafe to access the property.

If you have questions related to your credit extension or other matter, please contact Nancy Frantz (frantzn@whiteandwilliams.com; 215.864.7026), Steven Ostrow (ostrows@whiteandwilliams.com; 212.714.3068), Andrew Marrinucci (marrinuccia@whiteandwilliams.com; 215.864.6224) or a member of our Real Estate, Finance, and Financial Restructuring Groups.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates here.