

Workouts and Forbearance Agreements

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I. Introduction

While subprime residential loans led the way to the current financial and economic malaise, commercial real estate loans have in recent months been trending upward with respect to events of default. Retail loans are beset with credit problems due to the 2008 slumping holiday shopping season and the resultant bankruptcy or failure of numerous retail tenants. Residential Development loans, particularly resort development, face declining sales and withdrawal of institutional lenders from such lending lines. Industrial properties have fared better, but face uncertainty with stringent loan renewal requirements from lenders whose decided preference is to reduce real estate exposure in their portfolios. Multi-family projects may seek financing with Fannie Mae as a limited option, but face the same uncertainty with other lenders who have in many instances made institutional decisions to freeze their multi-family exposure. For the first time since the Great Depression, borrowers and their counsel may be sitting across the table from lenders whose futures are just as uncertain. The collapse of the CMBS markets leaves many questions concerning the roles of master servicers and special servicers and whether once loan pools reach maturity, inflexible rules will severely impair resetting loans for projects with stable fundamentals. This financial climate, perhaps more so than ever before, calls for close attention to detail and creative problem solving.

All commercial loans provide for legal and equitable remedies in the event of the borrower's default. Lenders, and their lawyers, are accustomed to doing exactly what the loan documents provide – when a borrower violates the loan covenants, the lender declares a default and accelerates the indebtedness and commences foreclosure or other loan enforcement proceedings. However, in 2009, relying on the remedies contained in the loan documents may not make as much sense as it used to. Because of the unavailability of buyers and funding for foreclosed real estate, a lender may find marketing its REO extremely challenging.

The lender's goal in enforcing a loan is to maximize recovery. In better economic times, enforcing the default provisions of the loan documents may be the best way to do this. However, with property values declining every day, rising storefront vacancies, and tightening credit standards, the expected recovery in event of default at loan inception may not achieve maximum recovery today. Creative-thinking, business acumen and damage control are more important than ever before to help the lender minimize loss.

If the facts support an alternative to foreclosure or accelerating the indebtedness, the lender may want to engage in a workout or enter into a forbearance agreement instead. These agreements are cooperative efforts between the borrower and the lender to continue the lending relationship after default under a varied set of terms from the original loan contract. The agreement will usually involve a lender's agreement to forbear from exercising its default remedies subject to the borrower's meeting certain conditions ranging from principal paydowns, additional collateral, securing of new leases, new guarantors or springing guaranties. The lender must be advertent to preference issues in the event of a bankruptcy. Guarantors and third parties are integral to this process.

This material will provide guidance from the perspective of the lender and lender's counsel entering into the workout of a troubled loan, but also affords borrower and its counsel insight into the lenders motivation and objectives.

II. The Borrower Has Defaulted – Now What?

In the first instance, all parties must understand in the current historical context, the reasons for the default and whether given such reasons a workout has any possibility of success. If the cause is vacancy due to tenant failure, is there a probability that replacement tenants can be secured in the current climate? Were the failures due to strategic flaws in the project, and are the vacancies attributable to key tenants without whom the project is not likely to be sustained? Is the default attributable in whole or in part to poor management of a related party management company, and if so, does the lender have the authority to demand replacement of the manager? If the loan is a construction loan, are there issues with governmental permits or regulations, is the loan over advanced, are liens filed or pending and is the general or prime contractor inept or financially unable to continue? A lender with a construction loan default must examine its priority to lien claimants' and governmental claims especially in light of the size and schedule of remaining funds to be advanced.

A workout is a joint attempt by the borrower and the lender to salvage valuable property and to avoid the delays and expense generated in foreclosure or a bankruptcy proceeding. Workouts are based on the idea that it is in the best interest of both parties for the lender and borrower to work together. There are no standard procedures, but tools available include extending or restructuring the indebtedness, accepting a discounted payoff, establishing an interest only period for rehabilitation or agreeing to forbearance for a period of time to permit the borrower to pursue a sale or refinance .

Workouts should only be attempted for properties that have a chance for success. If the parties agree that a workout is appropriate and feasible, they should act quickly as possible in order to identify and alleviate potential problems. If the borrower stalls, the lender must reserve the right to end the negotiations, foreclose, appoint a receiver or pursue guarantors. The issue today is whether there is a reasonable prospect of turnaround. Federal policy has been directed to bailing out banks and other financial institutions and a select class of residential borrowers, but to date has paid little attention to the threat of the collapse of commercial markets although federal policy makers are beginning to show recognition of problems created by mark to market valuation rules.

A. Step One: Double-Check for Default

Even if, at first blush, there appears to a certainty to be a default, check the loan documents for the definition of default. There may exist a difference between what constitutes a "material default" and a "non-material default," and case law does not define the difference. The lender's prior course of dealings may factor into whether a default is material.

The loan documents may also differentiate between a condition of default and an event of default. A default condition may be described as a curable by the borrower within a certain

period of time following the onset of the condition or notice from the lender, in which case the lender is not entitled to accelerate the debt or exercise its remedies. An event of default, depending on the determination may not be curable or subject to the notice requirement posturing the loan for acceleration of the debt and giving rise to the panoply of lender remedies.

There may also be a distinction between a cure period and a grace period. If the borrower is entitled to a cure period, notice of default and a period to cure is required. If the borrower is entitled to a grace period, no notice is required but the borrower nonetheless has the opportunity to cure within a defined period.

Despite the fact that an event of default exists according to the loan documents, the lender may have waived or be estopped from pursuing its right to accelerate the indebtedness. The lender's course of conduct is relevant. If a lender regularly accepts late payments, it may be deemed to have waived its right to accelerate the indebtedness until it notifies the borrower that prompt payments are again required.¹ A court may also consider a lender's advancement of funds to a borrower after default a waiver of its right to pursue its remedies.

B. Step Two: Look for Red Flags in the Loan Documents

In reviewing the loan documents, counsel will need to review for gaps, missing documentation and conformance with the lender's commitment requirements.

i. Review of Loan Documents

a. Possession. Does the lender have possession of the original Note? If not, this may be an issue at foreclosure or collection. Has the Note been assigned to MERS and does the jurisdiction recognize MERS right to act for the holder?

b. Exhibits. Are there missing exhibits?

c. Execution. Check to see that all documents have been properly executed by the appropriate parties and their authorized representatives. Review entity formation, qualification and suspension. Review the LLC Operating Agreement and resolutions for required approval and resolutions.

d. Notary. Be sure that all documents were properly notarized where required.

e. Names. Check for consistency of spelling of the borrowing entity and compare the name with the Secretary of State records. Is there a spouse who failed to join in execution?

f. Dates. Are the dates of all instruments consistent?

¹ Driftwood Manor Investors v. City Federal Savings & Loan Association, 63 NC App. 459, 305 S.E.2d 204 (1983).

Beware: The Eastern District of the Bankruptcy Court of North Carolina held that a promissory note was not enforceable after a debtor filed for bankruptcy where the promissory note was dated one day subsequent to the deed of trust and therefore was not a “promissory note of even date herewith” as referenced in the deed of trust. In re Head Grading Co., Inc., 353 B.R. 122 (Bankr. E.D.N.C. 2006).

But note: a possible contrary result issued. In re Easthaven Marina Group, LLC, Slip Copy, 2009 WL 484880 (Bkrcty. E.D.N.C. 2009).

g. Notice. What is the prescribed method of giving notice of default? If so, what type of notice, who is entitled to it (e.g., borrower, guarantor, landlord, other lenders, subordinating creditor, etc.), how may it be sent (fax, email, certified mail, etc.), and when is it considered received?

h. Special Property Types. If the security is a hotel, you need to check on an assignment of the ABC permit, the hotel management agreement and whether the lender has a lien on the linens, laundry, equipment, restaurant equipment and artwork. If the security is a retirement facility or a nursing home, will the Certificate of Need and licenses granted by the state be affected by a foreclosure? Will a receiver be able to enforce the licenses and permits? Church loans are problematical if the constitution or charter requires a congregational meeting or approval of the church hierarchy.

i. Tenants. Does the lender have SNDAs with the key tenants? Will the lender want to get rid of less creditworthy tenants?

j. Ground Leases. Ground leases pose special problems. If the loan is secured by a leasehold deed of trust, is there an agreement with the ground lessor granting lender notice of default and the right to cure? Does the lender have an obligation to give notice to the ground lessor?

k. Title Insurance. Review the policy for exceptions. Compare the survey with the policy description. Are there variances? Did the closing attorney obtain the requested endorsements?

l. Cross Collateralization. Are there multiple loans to the Borrower? Are they cross-defaulted and cross-collateralized? While the loan documents may contain uniform cross default clauses, cross collateralization must be intentional and established by each deed of trust by specific reference to collateral or to a prior or contemporaneous deed of trust.

m. Other Players.

-Are there other lenders? If so, what are the lien priorities, right to notice and opportunity to cure of the other lenders?

-Are there guarantors and/or other sureties? Have the guarantor's rights to demand lender's diligence to collect from the obligor or realize on security (N.C. Gen. Stat. § 26-7) been effectively waived? Borg-Warner Acceptance v. Johnson, 97 N.C. App. 575, 389, S.E. 2d 429 (1990)

-Was the security granted by the maker of the Note, and if not, was there a hypothecation agreement or a guaranty secured by the collateral?

Beware the disconnect: Where a nephew granted a deed of trust referencing himself as the debtor, and the promissory note was signed by his aunt and uncle, the court held the deed of trust was invalid and its grantee did not have a valid lien. See Putnam v. Ferguson, 130 N.C. App. 95 S.E. 2d (1998). In re Foreclosure of Enderle, 110 NC App. 773, 431 S.E. 2d 549 (1993).

-Are there other documents entered into by third parties such as intercreditor agreements, landlord agreements, subordination agreements, participation agreements, or letters of credit? Do such instruments require notice prior to acceleration or exercise of remedies?

ii. Check the Perfection and Priority of the Lender's Liens

a. Review:

i. Location of Collateral: If the property is in more than one county, multiple deeds of trust must be filed;

ii. UCC filings for proper filing location (State of principal office);

iii. Possession of collateral – does the lender have possession of collateral required for perfection purposes or is anyone else in possession of the collateral?;

iv. Location of the borrower;

v. Legal name change of the borrower;

- vi. UCC/tax/judgment lien searches, federal tax liens;
- vii. Title updates;
- viii. Whether state law grants unpaid employees a priority claim or lien;
- x. Recent environmental site assessments;
- xi. Are there UST's or hazardous waste deposits on the collateral? Does the lender risk becoming liable for contamination?

C. Step Three: Be Mindful of Borrower Defenses to Payment

a. Be prepared for the borrower to suggest one or more defenses to the lender's claim of a right to payment. The borrower may dispute that a default has occurred, claim that the statute of limitations has run, that the lender's rights are impaired by reason of usury, fraud in the inducement, oral waiver or agreement, the lender's failure to qualify to do business, the lender's failure to pay intangibles or documentary taxes, breach of a mortgage broker/mortgage servicer requirements, and issues involving sub-prime loans. Because during the 90's lenders evolved to be multi-faceted global service providers and investment vehicles, the borrower and its principals may have claims against lenders' affiliates.

b. Due to the state of the economy and the problems with sub-prime lending, lenders should also be mindful of recently enacted obstacles and statutes dealing with subprime loans and loans secured by primary residences. N.C. Gen. Stat. § 45-91 et. seq. and N.C. Gen. Stat. § 45-100 et. seq.

D. Step Four: The Pre-Negotiation Agreement

In an ideal world, the lender will require the borrower to execute a Pre-Negotiation Agreement prior to engaging in substantive discussions of workout details. The Pre-Negotiation Agreement will establish some or all of the following:

- (a) the identity of the parties, including servicers;
- (b) the obligation if any, to negotiate in good faith;
- (c) the admission of default;
- (d) the availability of remedies under the loan documents;
- (e) non-waiver of a fiduciary relationship between lender, servicer, borrower and borrower's principals;

- (f) the requirement of a single comprehensive forbearance agreement as opposed to fractured agreements;
- (g) designation of authorized representatives to bind the parties;
- (h) the disqualification of verbal commitments and inadmissibility of settlement discussions;
- (i) the right to discontinue negotiations and proceed with exercise of remedies (usually with short term written notice);
- (j) verification of performance by lender; and
- (k) exclusion of claims against lender and servicer(s).

E. Step Five: The Workout Meeting

Prior to the meeting, the resourceful lender will engage in informal discovery of issues that compel the borrower to work out the debt. The borrower may have problems with the loan terms and/or may also be negotiating with other creditors. The borrower's motivation may stem from other factors such as tax deferral, a desire to preserve its payment reputation, fear of having to disclose a tender of the collateral in subsequent loan applications and/or preservation of an equity investment.

The lender will also want to identify which, if any, mistakes to correct in the loan documentation. At this point, the lender should assess the borrower's and its principals financial history and anticipated future, assess the value of any collateral, and decide whether the borrower and its principals or guarantors are reliable and trustworthy. The lender should seek opinions on the liquidation value of the business, and communicate with co-lenders, mezzanine lenders, participating lenders and any other parties necessary to the workout. The lender must assess the reversals the principals/guarantors may have experienced in their assets including securities.

In the meeting, the lender will discuss the financial condition of the borrower, its projections for the future and the borrower's business plan. The lender will consider whether there are any assets available for use in the workout and the management and control policies and procedures to be used during the workout. A element of the latter may be the identity, relationship and performance of the property manager/leasing agent. At this time, the lender will propose a timetable for performance and verify whether borrower has, any dissatisfaction with the lender's handling of the loan administration and servicing. For income properties, the lender may propose a lock box arrangement for the securing of rents.

If the loan is for construction purposes, the lender should have on its agenda additional concerns to discuss with the borrower. For example, the lender must find out if it is protected against potential materialmen's or mechanic's liens that could be filed against the property. In doing so, the lender will want to determine whether any work was performed on site, such as

grading, prior to the closing of the loan. The parties should also address the physical status of the project and the nature of the claims against the project. If, the project is over advanced, the lender must be aware of the possibility of collusion between the borrower and the loan officer disbursing the proceeds.

F. Step Six: The Forbearance Agreement

The parties to a forbearance agreement will be, if applicable, the lender, servicer(s), borrower, guarantors, key principals and other creditors who may be parties to an intercreditor agreement. The agreement should acknowledge the principal amount of the debt remaining, accrued interest, late fees, the waiver of the borrower's and guarantor's defenses, offsets and counterclaims, and the enforceability of the loans and loan documents. The borrower must also acknowledge it has defaulted and the nature of this default under the loan documents. Recognition must be given to whether financial covenants are violated by borrower or guarantors and whether such default can be cured. The priority and perfection of the lender's liens should also be set forth in the agreement. If other lender parties are participants in the agreement, their debt should be characterized and the obligations from borrower to third parties established. The other lender parties should acknowledge notice of prior events, priority of subsequent payments, the borrower's default and establish what future notices are required.

The forbearance agreement should state the length and the terms of the forbearance period. This may include the acceleration of the debt, the exercise of remedies against the collateral, the accrual of a default rate of interest, the enforcement of rights against guarantors and other third party obligors, blockage notices and other rights against subordinated parties.

The parties should clearly set forth the conditions required to maintain status quo or to cure defaults. The lender will normally require that no other defaults occur and that the borrower and the guarantors or key principals, comply with specific financial conditions, pay loans and interest when due, adhere to a "forbearance budget," refuse to pay insiders, pledge additional collateral, pay payroll and associated taxes on time, pay rents into a lockbox and continue or begin utilizing a management or leasing consultant. The lender parties may desire a turnaround consultant be employed.

The agreement will address the consequences of a breach of the forbearance agreement. The lender may require that the outstanding debt be accelerated and that, upon the borrower's breach, it will have option to exercise remedies against the borrower, guarantors or collateral, repossess or foreclose upon the collateral, file any confession of judgment that may have been executed as part of the agreement, discontinue funding, appoint a receiver in an ex parte hearing and/or file collection actions against the borrower and guarantors.

The lender should articulate the ratification of the loan documents by the borrower and all guarantors, and insist the borrower and guarantors waive and release known defenses and counterclaims against lender or servicer as of the date of execution of the forbearance agreement. The borrower should also comprehensively waive and release any claims against the lender regarding its administration of the borrower's debt any previous exercise of remedies, such as notices to tenants under an assignment of rents.

If a lien has previously been subordinated by another creditor, the lender will want to obtain an agreement stating that the forbearance agreement does not affect the subordination of that lien.

The lender may choose from an assortment of other demands in the forbearance or workout agreement. Though not always an option for the borrower, the lender can require that the borrower provide additional equity and pay down the principal amount due. Potential issues with this requirement are that forbearance may not be considered “new value,” and this infusion of equity could create a preference problem. A lender might also require that the borrower provide additional guaranties, springing guaranties² or increase the exposure of limited guaranties. If the indebtedness is to be modified or extended, the forbearance agreement should set forth precisely the limitations of the modifications and whether the modifications are conditioned upon compliance with the performance mandates of the agreement.

If loan documents need repair or in the event new documents are required for a modification, they should be attached as exhibits or corrective provisions set forth verbatim. Borrower and guarantors should approve the repair provisions, agree to execute and record new documents.

The agreement must preserve or grant the lender’s right to have a receiver appointed as an independent right without borrower’s consent. Receivership statutory and case law is meager at best, but receivership remains an effective method to preserve rents without assuming the risks of becoming a mortgagee in possession. In most circumstances, lender’s counsel should not represent the receiver once appointed in order to avoid the linkage of the receiver’s subsequent acts. The lender’s officers may also need counsel about maintaining a disciplined approach of non-interference with the receiver in the prosecution of its responsibilities.

In return for forbearance, lenders often require that the borrower agree to forego the protection of the automatic stay should the loan restructuring fail and the borrower file for bankruptcy. Inasmuch as this is one of the chief inducements to the lender, we examine the validity of the waiver at length.

III. Waiver of the Automatic Stay: Is it Enforceable?

A. Introduction

In order to negate the effects of a subsequent bankruptcy, lenders often include waivers of the benefits of bankruptcy in mortgage modification and forbearance agreements executed during loan workouts prior to the filing of the bankruptcy petition. Such prepetition waivers attempt to preserve lenders’ access to state law remedies such as receivership, foreclosure, or assignment of rents. Though the Bankruptcy Code explicitly provides that some prepetition waivers are void and unenforceable, courts will uphold others if the proper circumstances apply.³

² FDIC v. Prince George’s Corporation, 58 F.3d 1041 (4th Cir. 1995)

³ Examples of such prohibited waivers include the following:

Among these prepetition waivers is the waiver of the automatic stay, which the Code does not expressly prohibit. By executing an agreement including a waiver of the automatic stay, the borrower agrees not to object to or to oppose the lender's motion for relief from the automatic stay in consideration for the lender's willingness to forbear from exercising its rights and remedies.

The automatic stay arises by operation of section 362(a) of the Bankruptcy Code, and its purpose is to halt all collection efforts against the debtor and its assets and to allow the debtor to create a plan to repay its debts. The stay prohibits the following, among other things:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under the title;
- (2) the enforcement, against the debtor or against the property of the estate, of a judgment obtained before the commencement of the case under this title;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate....⁴

The scope of the automatic stay is broad, but it does not universally protect the debtor. Section 362(d)(1) of the Bankruptcy Code authorizes a creditor to move the Bankruptcy Court for relief from stay to pursue its collateral where "cause" for relief exists. "Cause" is not defined in the Code and must be established by the facts and circumstances of the situation. Examples are failure of the borrower to insure the collateral, or "bad faith."

Relief from stay with respect to an act against property may also be granted under section 362(d)(2) if there is no equity in the property and it is not necessary to an

(1) Section 365(e)(1) invalidates contractual defaults arising from ipso facto clauses in executory contracts and leases conditioned on the insolvency or financial condition of the debtor or the commencement of a bankruptcy proceeding;

(2) Section 522(e) prohibits the waiver of exemption and avoiding powers;

(3) Sections 534(c) and (d) provide an exclusive set of requirements, including a rescission period, with respect to when a debtor may elect to waive its dischargeability rights by reaffirming debts;

(4) Section 541(c) invalidates any ipso facto clause with respect to property of the estate; and

(5) Section 1307(b) nullifies waivers of the right to dismiss or convert a bankruptcy case to another chapter under the Code.

⁴ See 11 U.S.C. § 362(a) (2005).

effective reorganization.⁵ The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) added section 362(d)(3), which provides that a lender with a claim secured by single-asset real estate may obtain relief from the stay unless, before the later of ninety days after bankruptcy filing or thirty days after the court determines that the case involves single-asset real estate, the debtor has filed a reorganization plan with a reasonable possibility of being confirmed within a reasonable time or has commenced monthly payments (which may be made from rents generated from the property) at the nondefault contract interest rate on the value of the creditor's interest in the real estate. Prior to the amendment, interest was payable at the current fair market value rate, which often involved an evidentiary hearing and disputed testimony.⁶

Creditors armed with post default-prepetition waivers of the automatic stay are hopeful that such a waiver will constitute "cause" under section 362(d)(1) to lift the stay. The Bankruptcy Code does not explicitly prohibit this manner of waiver, but courts will closely consider its enforceability. The federal courts have been inconsistent in their approach to waivers of the automatic stay, but they generally assess the same list of factors. Proponents of the post default-prepetition waiver argue such provisions are supported by new consideration of lenders' agreeing to forbear from exercising their legal rights and remedies.⁷ Supporters also argue that such waivers facilitate and effectuate prebankruptcy consensual workouts and encourage out-of-court restructuring and settlements.⁸ Opponents of the waiver counter they should be unenforceable because they are contrary to the rehabilitative goals of Chapter 11, usurp the authority of bankruptcy judges, and are burdensome to the estate. In the context of a "single asset case," at least one court has focused on the practical similarity between bargained-for prepetition waivers of the automatic stay and consensual restraints against filing for bankruptcy in the first instance.⁹

B. North Carolina Case Law

In In re Atrium High Point Ltd. Partnership, the Bankruptcy Court of the Middle District of North Carolina held that prepetition waivers of automatic stay protection contained in a post default agreement, are enforceable and not violative of public policy in appropriate cases.¹⁰ Addressing the argument that the practical effect of the waiver in a single asset case is to prohibit filing for bankruptcy protection, the court adopted the rationale that the debtor who has signed a waiver of stay has not waived its right to all protections of the Bankruptcy Code, has accepted the risk when it agreed to the waiver, and has bargained for the waiver in exchange for a loan modification.¹¹ The court implied that had the waiver been inserted in the original loan documents, the waiver would have violated public policy concerns,¹² but since the debtor received benefits

⁵ See 11 U.S.C. § 362(d) (2001).

⁶ See Pub. L. No. 109-8, § 444, 2005 U.S.C.C.A.N. (119 Stat.) 23, 117.

⁷ See, e.g., In re Checks, 167 B.R. 817, 819 (Bankr. D.S.C. 1994).

⁸ See Id.

⁹ See In re Jenkins Court Assoc. Ltd. Partnership, 181 B.R. 33 (Bankr. E.D. Pa. 1995).

¹⁰ See In re Atrium High Point Ltd. Partnership, 189 B.R. 599 (Bankr. M.D.N.C. 1995).

¹¹ Id. at 607.

¹² Id.

under a third modification from the lender, and the waiver was given in exchange for these benefits, the debtor bargained away its right to oppose a motion to lift the stay.

The waiver of stay in the Atrium case was limited, however, due to the effect the stay waiver had on third party creditors. The court heard objections from nine (9) third-party creditors who objected to the lender's motion. The Atrium court held that a waiver of stay cannot bind these third parties. Although the court upheld the waiver's effect by deeming the objection of the debtor to the motion for relief from stay meaningless, the court nonetheless was not convinced that waiver could overcome the legitimate objections of the other creditors. Citing the interests of other creditors, the court would not enforce the debtor's waiver against third-party creditors who had not waived the right to object to motion for relief.¹³

C. Factors to be Considered in Upholding the Waiver of the Automatic Stay

Most courts use a balancing process to determine whether the borrower's waiver is enforceable.¹⁴ If on balance, the factors support enforcement of the waiver, courts will do so.

In a case upholding the waiver, the following facts supported its enforceability:

- the lender granted concessions and incurred risks;
- there was material and substantial consideration given by the lender (e.g., reduced interest rate, advance of new money, extension of the maturity date, capitalized interest payments);
- the debtor and counsel acknowledged waiver voluntarily given after negotiations;
- the rights of third parties were not materially affected because there was no equity in the property;
- there was not a substantial change in circumstances and the property was not and never would be necessary to reorganization because there was no prospect of a successful reorganization;
- the waiver of the automatic stay was negotiated between financially sophisticated parties and experienced counsel.¹⁵

In a case in which the waiver was not upheld, the court cited the following factors in its decision:

- the case was not a bad faith, single asset case;
- bankruptcy was not filed at the last minute to thwart foreclosure;

¹³ Id. at 607-08.

¹⁴ It should be noted from the outset that a waiver agreed to at the time of loan origination is not likely to be upheld (particularly in North Carolina), while a waiver as part of a workout or confirmed plan may withstand a challenge.

¹⁵ See In re Shady Grove Tech Center Associates Ltd. Partnership, 227 B.R. 422 (Bankr. D. Md. 1998).

- the lender's claim was only a small portion of the claims against the debtor;
- the waiver was not part of a confirmed plan of reorganization that third party creditors could have objected to or approved.¹⁶

Other questions courts will often ask when determining whether to enforce a waiver include the following:

- Was the waiver obtained by fraud, coercion, or mutual mistake of material facts?
- How much time has passed between waiver and filing and has there been compelling change in circumstances during that time?
- Does enforcing the waiver promote legitimate goal/public policy of promoting out of court restructurings and settlement?

D. Tips for the Lender

A lender should restrict the use of the post default - prepetition waiver of the automatic stay to instances where the following circumstances apply:

- consideration has been established (i.e., forbearance, loan concessions, modifications from the lender);
- few, if any, other creditors have asserted claims (or the other creditors have consented in writing or executed a document, the workout agreement containing relief from the stay);
- competent counsel represented and advised the borrower;
- the agreement clearly states specific facts and circumstances supporting the finding of cause for relief from stay (such as a lack of need of the collateral for reorganization, few or no unsecured creditors, few or no employees, no equity in the property, and no assets other than the property); and
- the lender can conclusively demonstrate the outstanding loan balance exceeds the value of the property.¹⁷

In drafting the agreement, lender's counsel should be certain to state with particularity the factual circumstances surrounding the transaction at the time the documents are executed. Lenders would also be wise to consider that the enforcement of the provision is expressly subject to the approval of the bankruptcy court so that it is not implied that the lender is trying to oust the court of its jurisdiction and its authority to enforce the automatic stay. In one commentator's opinion, the waiver clause should be stated substantially as follows:

¹⁶ See In re Deb-Lyn., Inc., 2004 Bankr. LEXIS 200 (N.D. Fla. Feb. 20, 2004).

¹⁷ Judith Greenstone Miller & John C. Murray, Waivers of the Automatic Stay: Are They Enforceable (And Does the New Bankruptcy Act Make a Difference)?, 41 REAL PROP. PROB. & TR. J. 357 (2006).

In the event any of the undersigned, or their guarantor(s) shall become a debtor in any bankruptcy proceeding pursuant to 11 U.S.C. and lender shall seek relief from automatic stay pursuant to section 362 thereof, undersigned acknowledge(s) and agree(s) that the parties intend, as a negotiated condition of the making of this agreement, that: Lender be granted immediate relief from stay upon such happening; that this writing may be deemed conclusive evidence as to such negotiated ongoing intention of the parties; and that it is intended to remain the primary element in determining if cause exists for granting such relief.¹⁸

The lender should also remember to file a motion with the Bankruptcy Court seeking relief from stay on the basis of the waiver. Such waivers are not self-executing.

E. Changes Due to BAPCPA (to the Single Asset Realty Case)

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) enacted several provisions relating to single-asset realty bankruptcy cases that will increase the scope of the cases falling under that provision, provide more time for single-asset debtors to reorganize and may impact the enforceability of prebankruptcy agreements. The changes include the following:

- Section 101(51B), which defines “single asset real estate” cases, was amended to expand the number of debtors who may be “single asset real estate” debtors by eliminating the prior \$4 million debt cap (the definition excludes a debtor who is a “family farmer”).¹⁹ To qualify as single-asset real estate, income must not come primarily from business operations at the property. The definition would exclude, for example, hospitals, hotels, casinos, manufacturing facilities, ranches and marinas.

Courts will likely continue to be inconsistent in their decisions to uphold a waiver of the automatic stay. Bankruptcy courts will consider the enforceability of these clauses in the context of each individual case and in light of the existence of the factors listed above. In North Carolina, these waivers will not be upheld if inserted into in the original loan documents, nor will the waivers be binding on third parties not a party to the agreement if the third parties’ rights will be adversely affected. To best insure that a waiver is upheld, lenders should adhere to the guidelines set forth above.

IV. Waiver of § 45-21 16 Notice.

¹⁸ Irving D. Labovitz, A Review of Current Cases and Developing Trends Considering the Efficacy of Section 362 Automatic Stay Waivers in Commercial Mortgages,....or “What Do You Have to Lose”?, 103 COM. L.J. 271, 283 (1998).

¹⁹ See The Bankruptcy Abuse Prevention and Consumer Protection Act §1201, 119 Stat. at 193.

The notice and hearing required for foreclosures under power of sale, governed by N.C. Gen. Stat. § 45-21.16, are like the automatic stay in bankruptcy and may not be waived at the inception of the loan. However, a waiver to such notice and hearing may be effective if placed into the Workout Agreement.²⁰ Unlike the waiver of stay, the waiver of the § 45-21.16(d) hearing does not have to be supported by separate consideration, but the better practice would be to recite consideration in exchange for the waiver of hearing.

The statutory requirements are set forth in subsection (f) and require the original debt of \$100,000 or more, a memorandum signed by the party waiving notice and consent of the Clerk of Court. Because subsection (b) requires notice be sent to any person obligated to pay the debt (which would include original and any assuming obligors), notice required by the deed of trust and to every person having an interest of record in the security property, the lender must be very careful that all parties have waived the right to hearing, lest the foreclosure sale be flawed.

V. Equitable Subordination

Beware of junior lienholders who feel their rights have been prejudiced or their security impaired without their consent. The claim of equitable subordination often comes up in bankruptcy, though its application is not limited to that context. In order to determine whether a claim should be subordinated upon equitable grounds in a bankruptcy proceeding, most courts use a three-part test referred to as the Mobile test.²¹ The Mobile test requires that the following criteria is satisfied before a court will equitably subordinate a claim: (1) the claimant must have engaged in some form of inequitable conduct, (2) the misconduct must result in injury or harm to the creditors of the debtor, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.²²

Courts outside of the bankruptcy context have found equitable subordination appropriate where the terms of the debt have been materially altered without the subordinated mortgagee's knowledge and consent.²³ For instance, a purchase money mortgagee who agreed to subordination was entitled to be paid prior to a senior lender where the action of the borrower and senior lender prejudiced the purchase money mortgagee's rights.²⁴

VI. Lender Liability

The lender's role in the workout of a troubled loan poses more potential for liability than its role in the context of a performing loan. This is partly true because relationships are easy to manage when the loan is performing. Lenders face the potential for liability when, of necessity to preserve value, the lender must become more involved in the borrower's business operations when the borrower has defaulted. Because a workout requires the lender to take an even closer

²⁰ "In any case in which the original principal amount of indebtedness secured was one hundred thousand dollars (\$100,000), or more, any person entitled to notice and hearing may waive after default the right to notice and hearing by written instrument signed and duly acknowledged by such party." N.C.Gen.Stat. § 45-21.16 (f) (2005).

²¹ Matter of Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977).

²² In re Giorgio, 862 F.2d 933 (1st Cir. 1988); Matter of Lifschultz Fast Freight, 132 F.3d 339 (7th Cir. 1997); In re Bellanca Aircraft Corp., 850 F.2d 1275, 7 U.C.C. Rep. Serv. 2d 656 (8th Cir. 1988).

²³ Gluskin v. Atlantic Savings & Loan Ass'n, 32 Cal. App.3d 307, 322, 108 Cal.Rptr. 318, 323 (1973).

²⁴ C&S National Bank of South Carolina v. Smith, 277 S.C. 162, 284 S.E.2d 770 (1981).

look at the borrower's financial situation, a borrower is more likely to claim that the bank is controlling its business and day-to-day operations. When this element of control is present, lending institutions, subject themselves to more viable and significant claims. Borrowers also will rely on oral or written communications outside of the lending documents because much more communication is involved in the workout process than in a normal performing loan context. Proper and professional communication is most critical in a workout situation in order for the lender to avoid liability.

The theories of lender liability are limited only by the imagination of borrowers, guarantors, and their attorneys. Some commonly used theories of liability include the following: breach of contract, breach of fiduciary duty, breach of duty of good faith and fair dealing, fraud, duress, tortious interference, control of the borrower, and negligence in processing, making or administering the loan. These theories are often advanced simultaneously based on the same set of facts, and courts will apply different theories to reach the results on the same set of facts.

It is important to note that many of the lender liability theories are based in tort, not in contract. The distinction may be important with regard to applicable statutes of limitations, conflict of law rules and the availability of attorneys' fees and punitive damages.

If not just to avoid the cost of litigation, lenders should be mindful of the potential for liability for public relations purposes. Jurors, and the general public, may react negatively even to mere accusations against the lender. Jurors may react in an unpredictable manner when they hear that a bank has been accused of fraud, duress, lack of good faith and violation of usury laws.

In order to avoid the potential for liability and for public denunciation, the wise lender will follow the following basic guidelines:

(1) Do not make a sudden move. Regardless of the language of the documents, always assume reasonable notice is required. Unless giving notice and a reasonable opportunity to respond would materially harm the lender's position, the lender should consider giving notice of the declaration of default and exercise of its remedies. If the lender engages in a workout, the negotiations may create an expectancy of no sudden moves without some sort of notice.

(2) Do not tell a lie (or bend the truth). Clear communication is critically essential in the context of a workout. If the lender allows deferred payment or any other manner of deferral, the lender must be clear that the deferral is without prejudice and it retains its right to pursue remedies should negotiations fail. Otherwise, the borrower may be able to claim waiver or course of dealing as a defense.

(3) Do not accept an opportunity to run the borrower's business. Lenders sometimes "trade" interest accruals for a "back-end" equity participation. By doing so, lenders are establishing a closer relationship with the borrower, which makes control a more viable claim for the borrower.

(4) The lender risks the wrath of the US Attorney if it winks in a knowing way while the borrower completes lender's project with funds from another lender's loan.

(5) Keep the files clean. The lender should make sure its files do not include any disparaging remarks or comments about the borrower. Constant vigilance must be used to remind employees the discoverability of e-mails.

(6) Transfer the loan to a special assets workout officer. A fresh view of the loan will not only help pick up on mistakes in the loan documentation, but also ensure that the lender is maintaining a fair and objective perspective.

(7) Confer with counsel. The lender should not act – especially if the act requires notice to the borrower – without conferring first with its counsel.

(8) Be careful in preserving deficiency claims. Potential jurors may be sympathetic to a distressed borrower, especially in this economic climate.

(9) Avoid arrogance. As in legal and medical malpractice claims, borrowers too are less likely to sue a lender whose officers are empathetic to the borrower's difficulties.

VII. What if the Workout Fails?

Even though both parties hope to reach an agreement, a workout may fail for a number of reasons. The borrower and lender may not be able to agree on the terms of the loan modification. It may be that the borrower is unwilling or, especially in the down economy, unable, to infuse additional capital. The value of the security property may have fallen precipitously and the borrower may have no option but to hand over the keys. Another reason for failure could be that the borrower or lender wants out of the deal altogether. In other cases, workouts fail due to forces beyond either party's control, such as the actions of a third party.

Having performed the necessary pre-workout due diligence in its preparations for a workout negotiation, the lender will be more nimble in taking action should the negotiations fail or the borrower default after execution of the workout forbearance agreement.