WORKOUTS AND FORBEARANCE AGREEMENTS

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Comprehensive underwriting, coupled with careful documentation, typically minimizes a financial institution's risk when extending credit or making loans. However, when lending officers make loans, they don't always think about the consequences in the event of a default at some point down the line. Accordingly, sometimes a lender fails to pay attention to details that could ultimately have an adverse effect when the bank needs to exercise its legal remedies. For example, a lender might not notice that guarantors live in one jurisdiction while the borrower is incorporated in another state. As a result, the guarantees might not contain the requisite language for the bank to confess judgment in the jurisdiction where the guarantors live. When reviewing a file in anticipation of making a loan, a lender might not focus on all of the information contained in tax returns or credit reports. Ultimately, this inattention might have adverse consequences, for example in a non-dischargeability proceeding in an individual guarantor's bankruptcy.

After a loan goes into default, rather than simply litigating, which is expensive and time consuming, often a lending institution will attempt to work out or restructure the debt so as to have a performing loan on its books. This workout option, typically in the form of a forbearance agreement, provides an opportunity to clean up any omissions in the original loan documents, to add protection (like cross defaults and cross collateralization) and to obtain additional collateral to secure the loan.

Details to Which Attention Should Be Paid

It is imperative that when making a loan, a lending officer should pay careful attention to detail. For example, failing to notice that a signature has been notarized or accepting signatures outside of the presence of a guarantor can lead to affirmative defenses when suit is filed. Borrowers and guarantors may assert that the signature is not really theirs or that they did not see the entire guaranty and were only presented with a signature page, believing they were signing a different document. Similarly, in loan documents that contain confessed judgment[1] language, it is crucial to pay attention to where the guarantors live because different jurisdictions have different requirements for entering judgments. For example, in Maryland, one can use generic language providing for any attorney to appear on behalf of the defendant to enter judgment. On the other hand, Virginia requires specific language naming a particular person who is authorized to enter confessed judgment (and that person actually has to go to court to file the judgment).

The consequences of not being able to enter a judgment immediately in the county where the guarantor or borrower lives can be significant. In most jurisdictions, entry of a judgment operates as a lien on any real estate a judgment debtor owns. If the loan documents do not have the correct confessed judgment language, a lender could lose its priority by the time a judgment is entered in one jurisdiction and then transferred to the judgment debtor's county of residence.

Another item to pay close attention to is what information the borrower and/or guarantors provide in support of a loan application, like personal financial statements or credit reports that should alert a lender that the applicant is married. Most financial institutions' form financial statements have a box to check whether the statement reflects joint assets or only the applicant's assets. For example (check one):

❑ Individual Financial Statement	❑ Joint Financial Statement (if joint, complete the following)
Spouse: ______________________	Date of Birth:______________________
	Social Security No. __________________

However, frequently, lenders do not really insist that the applicant check the box or do not inquire if, in fact, the financial statement reflects only the applicant's assets.

The potential downside of failing to pay attention to this detail is that, after default, an individual borrower or guarantor files for bankruptcy hoping to obtain a discharge of all of his debts. The lender then seeks to have the debt deemed to be non-dischargeable because the financial statement reflected a $10 million net worth while the debtor's bankruptcy schedules show only $4 million in assets (because the schedules do not includes assets owned either jointly or as tenants by the entirety).

Section 523(a)(2) of the Bankruptcy Code provides that a debt will be non-dischargeable if money was obtained by use of a written statement (in this example, a personal financial statement) that is materially false as to a debtor's financial condition on which a creditor reasonably relied that the debtor published with intent to deceive (a creditor must satisfy all of these elements). The key here is the part which requires reasonable reliance. Courts have found that when a lender has had information in its possession indicating that a debtor was married (for example, tax returns or credit reports), and therefore should have known that joint assets could not be relied on as collateral for the loan or guaranty, that lender did not reasonably rely on such financial statement in extending credit.

Forbearance Agreements

In the event that a lender has neglected some of the details discussed above, there is sometimes an opportunity to perform corrective surgery. When a loan is in default, most lenders would rather restructure the loan than spend money on litigation. Often, restructuring terms are memorialized in a forbearance agreement which provides that the lender will refrain from exercising its legal remedies upon the obligor's fulfillment of the obligations set forth in the agreement. This is a golden opportu-

nity to rectify any omissions or errors in the original documents as well improving the lender's collateral position.

If the loan documents have not been executed properly or have not been notarized, a forbearance agreement is a good vehicle to include borrower and guarantor reaffirmations as to the amount of outstanding debt, that the loan documents are valid and binding and also to include a waiver of all defenses and counterclaims. To the extent that the wrong confessed judgment language was used in the original loan documents, or if no confessed judgment was included, the forbearance agreement should include such language.

A lender should also use the forbearance as an opportunity to add collateral if possible (additional real estate or liens on assets) or at least to cross collateralize different loans with existing collateral. When obtaining additional real estate collateral, because of the recordation taxes, it often makes sense to limit the amount of indebtedness secured by the new deeds of trust to the amount of estimated equity in new property added as collateral. For example, rather than adding three new deeds of trust, each of which secures the total outstanding indebtedness in the aggregate amount of $4 million, a lender might choose to obtain deeds of trust in small amounts that will provide the lender equity but not require unnecessarily high recordation fees.

To the extent that existing loan documents do not contain cross-default provisions, a lender should take the opportunity to add in such a provision. An agreement with both cross-collateralization and cross-defaults will broaden a lender's rights and remedies significantly. One final provision that is often added in forbearance agreements relates to bankruptcy. Adding language in which the borrower and guarantors acknowledge that in the event of bankruptcy such obligors will not object to or contest a lender's request for relief from the automatic stay[2] can short circuit any attempt to delay the enforcement of remedies by filing a bankruptcy petition. Many courts have upheld such provisions in granting lenders relief from the automatic stay.

Conclusion

In an ideal world, at the outset of a loan, all of the documents would be executed perfectly and every loan would be over-secured. Unfortunately, reality does not always work that way and therefore it is sometimes necessary to try and correct omissions or to add to a lender's remedies. Upon a borrower's default, drafting a forbearance agreement can remedy deficiencies and can increase the likelihood that a lender will be repaid. Once a borrower has defaulted, the lender is bargaining from a position of strength (in terms of agreeing to forbear from exercising remedies) and should take advantage of this situation to improve its position. TSL

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1. A confessed judgment allows a creditor to enter judgment upon default rather than having to go through an entire trial that could take months or years.
2. Section 362 of the Bankruptcy Code imposes an automatic stay against the commencement or continuation of any legal action or attempt to enforce remedies against a debtor.

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