



DEFAULTS AND FORBEARANCE AGREEMENTS

ABA Business Law Section Spring Meeting

Joint Meeting of the Loan Workouts Subcommittee, Lender Liability Subcommittee and Real Estate Finance Subcommittee

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WHAT WE WILL COVER (AND NOT COVER)

- We are covering commercial loans and asset-based loans
- We are *not* covering consumer loans
- We are covering defaults and the decisions and issues about forbearing from exercising remedies
- We are *not* covering the loan documents and what they contain
- We are *not* covering remedies

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DEFAULTS

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- Monetary defaults, e.g.:
 - Failure to pay principal at maturity
 - Failure to pay installment of interest
 - Failure to pay some other indebtedness (e.g., insurance premiums, taxes and assessments)
- What is the business plan to cure? Is the business plan feasible? Does it appropriately limit lender's risk?

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- Non-monetary defaults and whether they can be cured, e.g.:
 - Cancellation of leases
 - Unauthorized sale or transfer of collateral
 - Death of guarantor
 - Failure to maintain improvements or comply with applicable laws

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- Breach of debt service coverage ratio [DSCR]...
 - None can be cured by the payment of delinquent debt, see Cal. Civ. Code § 2924c, subd. (a)(1)
 - But can secured party accelerate?
 - *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979) (courts will examine fairness/equity of acceleration)
 - See also Cal. Civ. Code §§ 3275, 3369
 - Event of Default language – automatic default or notice time period
 - Inconsistent provisions for defaults and cures

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- What kind of collateral?
- Personal or real property?
- Special considerations?
 - Nature of the collateral often compels treatment:
 - Compare construction loan where the office building is nearly complete, and costs to finish it vs. specialized equipment to manufacture something obsolete but still used
 - (VHS tapes/computer components/auto carburetors).

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- Can lenders recover default interest and/or late fees?
 - *Gen. Elec. Capital Corp. v. Future Media Prods., Inc.*, 536 F.3d 969 (9th Cir. 2008), amended 547 F.3d 956 (9th Cir. 2008)
 - Cal. Civ. Code § 1671(b) (unlawful penalty?)
 - *East West Bank v. Altadena Lincoln Crossing, LLC*, 598 B.R. 633 (C.D. Cal. 2019) (reasonable estimate of damages?)
 - But see *Honchariw v. FJM Private Mortgage Fund*, 83 Cal.App.5th 893 (Sep. 29, 2022) (assessed pre-maturity v. upon a maturity default)
- Is usury a concern?

- Is one-action (or single action) rule applicable?
 - Cal. Code Civ. Proc. (“CCP”) § 726(a); see also *Sec. Pac. Nat’l Bank v. Wozab*, 51 Cal.3d 991 (1990).
 - But what constitutes an “action”? What does not?
- “Security first” concerns?
 - As the second element of the one-action rule, the lender must exhaust its security before suing the borrower directly on the debt. (CCP § 726.)

- Modified anti-deficiency approach ...
 - See Tennessee Code Annotated §35-5-117: foreclosure sale price = FMV;
 - Two years to bring suit for post-foreclosure deficiency.

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- What is governing applicable law in document for default and for remedies?
 - Check choice of laws provisions in the security agreements/deed of trust

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- Loans secured by personal property are generally covered by the UCC, which is the same in most jurisdictions;
- Default/remedies often apply the laws of Lender's preferred jurisdiction.

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- Some jurisdictions allow separate choice of law carve-outs (to apply the law of another state) for interest, loan charges, commitment fees, and brokerage commissions.
 - See Tennessee Code Annotated § 47-14-119.

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- Recent developments:
 - Public policy issues outweighing contractual choice of law provisions.
 - See, e.g., *Carmel Financing, LLC v. Schoenmann*, 2022 WL 3599561 (N.D. Cal. Aug. 23, 2022) (declining to apply the contractual choice of law provisions.)

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FORBEARANCE AGREEMENTS

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- No Model Agreement but have attached 2 or 3 examples of agreements
 - See Subcommittee Platforms

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- Is a pre-negotiation letter desirable?
 - See Subcommittee Platforms

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- What lender liability concerns should the lender have during this period and try to avoid?
 - Any dispute by borrower concerning the factual aspects of the loan and existing defaults
 - Any claim by borrower that lender made oral promises

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- Any argument that lender has waived its rights and remedies by delaying some action.
 - See, e.g., *Vaneiser v. Nebraska Bank*, 2017 WL 1229931 (Neb. App. 2017)
 - *Bailey Tool v. Republic Bus. Credit*, 2021 Bankr. LEXIS 3502 (Bankr. N.D.Tex. 2021)

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- Waiver of identified default(s) or postponement of declaring default?
 - Try to avoid waivers if possible
 - Where they cannot be avoided, waivers should be:
 - Specific / limited / not blanket
 - Short term
 - Written and clearly labeled as such
 - Prepared by counsel
 - Oral waivers should be avoided
 - Failure to act can constitute a waiver (unless the agreement expressly states that it does not)

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- Time frame for forbearance? Is it too short to work? Rolling forbearance?
- Or is longer period better? Depends on the business solution:
 - Amendments are preferred since they allow for continued covenant protection (see examples). But:
 - Serial and constant amending imply a loan structure problem or more serious financial problems. And:
 - Forbearance agreements are often used in an “exit” mode, so may not be appropriate to grant a longer-term amendment or restructure.

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- What default interest payment or principal reduction is needed at start or during the forbearance period?

- Forbearance fee? Attorneys' fees? Costs of collection?

The decision often comes down to what the parties are trying to accomplish and their planned objectives. Personal relationships and communication go a long way in these negotiations.

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- Default interest is usually the first that Lenders are willing to part with, especially given usury concerns.
 - But see, Tenn. Code Ann. §47-14-107 (Tennessee's General Usury Statute does not limit or restrict the manner or method of contracting for interest, whether by way of add-on, discount or otherwise, so long as the maximum effective rate is not usurious).

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- Forbearance fees are often found in CRE loans with a Guaranty and a solvent Guarantor. Principal reduction is usually the last thing a Lender will consider.

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- Attorneys' fees, expert fees, appraisal fees, litigation costs, foreclosure expenses and all other costs of collection are almost always added to the indebtedness,
 - Sometimes reimbursed as a separate, preliminary payment in forbearance.

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- What benchmarks, conditions or milestones are required?
 - Additional or shorter periods for reporting, budget, restricted accounts, additional advances by lender, start sale process, hire new financial advisor or chief restructuring officer, change broker, etc.?
 - Clarify forbearance period and termination date
 - State conditions for forbearance to take effect

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- Again, depends on the business:
 - Require that borrower (i) hire a broker, (ii) enter into a listing agreement, and (iii) enter into a sale agreement for some minimum price, all within certain time frames
 - Require that borrower receive capital infusion of no less than certain amount, by date certain
 - See, e.g., *Bailey Tool v. Republic Bus. Credit*, 2021 Bankr. LEXIS 3502 (Bankr. N.D. Tex. 2021);
 - *Sandander v. Santili Ent.*, Mass.L.Rptr 638 (2018); *In re Lyondell Chemical*, 2018 WL 565272 (SDNY 2016)

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- During forbearance period will lender make additional advances?
- Is availability tightened or changed, or revenues received apply to reduce debt or be drawn and used by borrower?

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- TBD on a case-by-case basis:
 - Lender must balance limiting risk with enabling the borrower to continue operating
 - Forbearance agreement should provide lender with sufficient protection and “step up” provisions should material financial deterioration occur
 - Agreement also must support borrower’s efforts at resolving the EODs

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- Does the lender want additional collateral or guaranty?
- Or cross collateralization?
- Consideration for it?
- Preference or fraudulent transfer?
- If lender has an insufficiency with its collateral or perfection, should the lender be allowed to fix it during this process?

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- Should lender get a release from borrower of all existing causes of actions as a part of this forbearance? Consideration?
 - Yes, as to any, and all, claims arising under the loan documents as of the Effective/Execution Date of the forbearance agreement
 - Also include borrower's release in the pre-negotiation agreement
 - Lender's accommodations (e.g., willingness to negotiate, conditional forbearance, etc.) generally constitute consideration for releases provided after borrower's default

- Are “bankruptcy clauses” -- e.g., borrower’s agreements not to file a petition, not to contest stay relief, not to prime with DIP financing, or findings of equity or adequate protection -- enforceable provisions?
 - See *In re Thorpe Insulation, Co.*, 671 F.3d 1011 (9th Cir. 2012) (reaffirming that a debtor’s prepetition waiver of Bankruptcy Code protections is against public policy); but see:
 - *In re ICPW Liq. Corp.*, 600 B.R. 640 (Bankr. C.D. Cal. 2019) (debtors’ prepetition state-law releases were not void as against bankruptcy policy)
 - *In re A. Hirsch Realty, LLC*, 583 B.R. 583 (Bankr. D. Mass. 2018) (approving prepetition waiver of automatic stay in narrow contexts)

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- In addition to lender liability, should the lender be concerned about equitable subordination under section 510 of the Bankruptcy Code?

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- What do you do at end of forbearance and you want to return to regular documents and performance?
- Anything formal?
 - As always ... it depends.
 - The Forbearance Agreement should have a designated “Forbearance Period” during which the modified obligations apply, but which terminates on a specific date, then reverting to the previous terms.
 - Workouts on construction loans sometimes apply for longer periods—up until cash flows start with tenantable space leased out, lots sold or production starting.

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QUESTIONS?

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