Maximizing Recovery of Distressed Debt*

By Scott A. Lessne and Vincenzo Paparo

Lenders must understand the full scope of enforcement remedies.

CCH
a Wolters Kluwer business

The past several years have been a busy time for financial markets. The economy has exhibited consistent economic growth, and an unprecedented amount of capital has been made available for investment. As a result, new debt structures, new debt providers and new debt products have become available for commercial borrowers creating an overheated and highly risk tolerant debt market.

While lending activity and opportunities have continued to grow, it appears that the steady economic growth of the past five years has slowed, possibly foreshadowing a slowdown that will directly affect lenders in all parts of a company's capital structure. The recent rapid meltdown of the subprime mortgage lending industry amply demonstrates how quickly an industrywide credit problem can leave lenders with little time to rationally analyze a problem and to prepare a strategy to enhance recovery.

Similarly, the overnight shutdown of the capital markets in the early part of the decade found many lenders creating their debt recovery strategies on the fly. Warning signs went unnoticed, opportunities to prepare and plan recovery strategies were ignored, and significant losses were incurred. While experience shows that one should always be prepared for restructurings, the impending shift in the economy suggests that there is not a better time than now to focus on potential problem credits.

When a credit exhibits signs of financial distress, lenders have various enforcement and recovery options. This article will review those options, with emphasis on *being prepared to act*.[1]

Restructuring the Debt

Generally, a successfully negotiated restructuring of a loan is preferable to outcomes achieved as a result of enforcement actions. Lenders should not, however, shy away from commencing appropriate enforcement action if a borrower needs some encouragement to engage in or complete a satisfactory restructuring. As we will see below, enforcement does not necessarily mean an all-out litigation battle. Timely and limited use of enforcement actions can be used effectively to achieve a tactical advantage to enhance the restructuring process.

Lenders today are faced with numerous options when pondering the possibility of restructuring distressed debt. The options available are often narrowed by internal and external considerations, including (1) the investment return objectives of the lender; (2) the nature of the borrower's difficulties, that is, financial covenant defaults vs. payment defaults; (3) industry-specific trends; (4) liquidity in the market for distressed debt; and (5) third-party pressures on the borrower. Most important, however, lenders should factor into the restructuring equation the contractual relationship between the

Scott A. Lessne is the General Counsel—Corporate Operations and Corporate Compliance Offcier of CapitalSource Finance LLC. Contact him at slessne@capitalsource.com.

Vincenzo Paparo is a Partner in the Corporate Department and Co-chair of the Finance Group of Proskauer Rose LLP. Contact him at vpaparo@proskauer.com.

The authors thank Joseph Choi, an Associate in the Corporate Department and Finance Group of Proskauer Rose LLP, for his assistance with this article.

borrower and the lender. One could argue that the seeds of a successful or failed restructuring are sown at the time the loan is initially negotiated and closed. Today's "covenant-lite," borrower-friendly credit agreements; multitranched capital structures; and lender syndicates comprised of various institutional interests will make consensual debt restructures more challenging than ever. While consensual restructurings will always continue to play an important role in the resolution of distressed credits, nonconsensual enforcement options (to the extent not negotiated away at the outset of the transaction) will likely play a more prominent role during the next economic downturn.

Enforcement: When Does It Start?

Restructuring and enforcement is a process moving along a continuum where institutional objectives are the controlling factor. Institutional objectives will drive the pace of the restructuring and the breadth of available enforcement options. Lenders should clearly communicate institutional objectives to counsel and other professionals engaged to assist in the restructuring and enforcement process. For example, some institutions may view a series of financial covenant defaults as a signal that a credit weakness exists. The credit is moved to a restructuring unit, which then executes the institution's objectives. Another institution may be more risk tolerant and view a series of covenant defaults as opportunities to obtain further leverage through waivers or forbearance agreements coupled with additional fees; the defaults are not sufficiently serious to sound the alarm. Therefore, the first step is to understand your institution's restructuring and enforcement philosophy. Subsequent actions by the deal team and the restructuring team should align with this philosophy. One should also periodically step back and confirm that the institution's philosophy toward the specific credit, the borrower's industry or other internal portfolio management concerns have not shifted in a significantly dramatic fashion so as to warrant a wholesale revision of the underlying initial strategy. Many lenders, but particularly those driven by quarterly public reporting requirements, are prone to adjusting their philosophies midstream in order to achieve big-picture corporate goals. While there is nothing inherently wrong with a philosophical shift in approach, it makes the job of the people in the trenches that much more difficult if the philosophy shift requires a significant change in the restructuring strategy.

Review Your Enforcement Options

After identifying the strengths and weaknesses of the credit together with the relevant industry trends that may affect them, it is important to formulate a strategy to enhance the recovery of the debt. While deviations from the initial strategy are inevitable, the initial path to achieving the end result should always be kept in sight as a benchmark. A lender may consider a number of options when developing its debt recovery strategy. A prudent lender will carefully evaluate the widest array of options available to it at that point in time. These options will include contractual business decisions, such as implementing a default rate or terminating advances (if contractually permissible) and decisions such as whether to aggressively pursue legal rights with or without judicial assistance. This determination may depend on certain factors, including but not limited to the law of the state where the borrower and/or any collateral is located, the cooperation of the borrower, the presence of other creditors holding an interest in the collateral and the various implications of a bankruptcy filing.

The recent rapid meltdown of the subprime mortgage lending industry amply demonstrates how quickly an industrywide credit problem can leave lenders with little time to rationally analyze a problem and to prepare a strategy to enhance recovery.

While a full discussion of a lender's rights in bankruptcy are beyond the scope of this article, a

CCH a Wolters Kluwer business

note of caution is appropriate here. Enforcement options should always be viewed against the backdrop of a possible bankruptcy filing. More than once, a lender has marched down the path of enforcement only to be faced with a bankruptcy filing that the lender believed or was told would never occur. The authors have been witness to explanations of lender surprise such as the following: "We believed that the CEO was too honorable to file." "We thought the company did not have enough money to file." "He wouldn't dare do it without talking to us or finding a new lender first." To the surprise and the detriment of these lenders, bankruptcy filings occurred in each instance. The analysis is simple. What is the realistic likelihood that the enforcement action will precipitate a bankruptcy? If the realistic answer is likely or better, then the lender should consult with counsel and its financial consultants to develop one or more bankruptcy outcome models. Those outcome models should be used to balance the bankruptcy outcomes against outcome alternatives that could result from restructuring paths other than the chosen mode of enforcement. When viewed in light of a bankruptcy, a negotiated resolution, a sale of the loan or another nonconfrontational strategy may be a preferred course of action. Again, the institutional philosophy toward the specific credit or the borrower's industry or a whole host of other internal factors will play an important role in this analysis.

CCH a Wolters Kluwer business

Enforcement Options Available to a Lender

Enforcement options run the gamut of escalating severity as follows: sending a notice of default and reservation of rights; implementing a default rate; terminating revolving advances (if allowed under the credit agreement); accelerating the loan; entering into a waiver, amendment or forbearance agreement; exercising self-help remedies; seeking judicial assistance (enforcement of contractual obligations, money judgments, receivership or bankruptcy); or, where appropriate and applicable, filing an involuntary bankruptcy petition. The process is not linear, and many of these and other related enforcement options may be implemented simultaneously. In fact, a multitrack carrot-and-stick approach is often advisable and should be considered as the situation warrants. Section 9-601 of the Revised Article 9 of the Uniform Commercial Code (RA9) expressly sanctions the use of multiple enforcement mechanisms.

Assuming the lender and the borrower have reached an impasse, that is, the borrower is unresponsive or unwilling to enter into a negotiated resolution satisfactory to the lender (which can occur either before, during or after one or more forbearance agreements), the lender is now faced with the choice of either finding a method to motivate the borrower to cooperate or undertaking unrelated enforcement actions. Below, we describe actions that a lender may initiate that may result either in the borrower reengaging in cooperative activity or in legal action against the borrower and/or the collateral.

Nonjudicial Remedies

Part 6 of RA9 provides a variety of options for the secured lender after a default has occurred under the lender's loan documents. Lenders should note that RA9 does not provide a definition of default, nor does it provide guidance as to when enforcement action should be initiated after a default. Whether the lender is entitled to act upon a default and the timing of such action are issues governed by the terms of the loan documents and law outside of RA9.

The enforcement provisions of Part 6 of RA9 focus on the collateral for the loan. Unsecured lenders generally will need to rely on their credit agreement, other state law and the Bankruptcy Code to enforce legal rights. Part 6 of RA9 provides a variety of options that may be employed singly or in combination with other enforcement mechanisms. The RA9 drafters sought to provide an efficient and effective method for a secured lender to realize upon the value of its collateral without the associated time and expense of protracted litigation or a bankruptcy proceeding. In order to take advantage of the Part 6 provisions, the lender will need to be aided by either a genuinely cooperative borrower or a borrower who has been motivated by the lender to assist in the process of unlocking the value of the collateral. Note that for RA9 purposes, we are assuming that the borrower is a "debtor" as defined in RA9. Absent some level of cooperation, the Part 6 provisions of RA9 may be of limited utility.

The enforcement mechanisms authorized in Part 6 of RA9 are as follows:

- Collection of payments from account debtors through notification or judicial assistance and access to any collateral securing those payments
- If the secured party is also the borrower's depository institution, application of the balance in the borrower's deposit accounts to the outstanding loan
- If the secured party is not the depository institution but has a security interest in a borrower deposit account that is perfected by control, instructing the depository bank to pay the balance in the deposit account to the secured party for application to the loan
- Taking possession of the collateral with judicial process or without judicial process provided, however, that if self-help is the option chosen, the secured party may not commit a breach of the peace
- Rendering equipment unusable and disposal of the collateral on the borrower's premises
- Selling, leasing, licensing or otherwise disposing through a public or private disposition any or all of the collateral in its then-existing condition or following commercially reasonable preparation
- Accepting the collateral in full or partial satisfaction of the debt

Reviewing the specific steps that a lender must follow to execute on one or more of these various options is beyond the scope of this discussion. It should be noted, however, that while RA9 provides effective and efficient procedures for a secured lender to realize upon its collateral, RA9 can also be a trap for the unwary. Much litigation has arisen over a lender's use of these processes under the prior version of Article 9. The bulk of the litigation is primarily due to lender inattention to the Article 9 rules or overzealous activity, mostly in the areas of commercial reasonableness of dispositions, breach of the peace and valuation of the collateral for deficiency purposes.

Further, initiation of one or more of the RA9 enforcement options without at least a modicum of cooperation from the borrower may precipitate a bankruptcy filing or result in a lender liability claim. While a bankruptcy filing may be the consequence intended by the initiation of the RA9 process (a perfectly valid strategy if planned for under the right circumstances), in many instances lenders do not anticipate and plan for this consequence. The bankruptcy will immediately bring to a halt all RA9 enforcement activity and will force the lender into the world of bankruptcy law and bankruptcy lawyers.

Finally, lenders must consider the impact of RA9 enforcement activity on the borrower's business and on other creditors. For example, if the secured lender redirects all of the borrower's cash collections or empties a borrower's deposit account, in most instances the impact will be immediate and dire. Take care to assess the consequences of this action in the context of facts and circumstances uncovered during the initial restructuring due-diligence process. Numerous lenders seeking to shut off a borrower's access to cash have found themselves in trouble over unrecognized course-of-dealing issues.

Judicial Remedies

The lender may pursue judicial remedies against the borrower and/or any guarantor by commencing a legal proceeding in state or federal court. The lender generally will commence its action in state court, as federal subject matter jurisdiction by virtue of a federal claim or diversity is not always available in proceedings involving the collection of debt. Generally, the loan documents will provide the governing law, jurisdiction and venue for any actions taken with respect to the loan and usually are enforceable against the parties to the loan documents. In most states, the lender may pursue multiple judicial remedies by commencing a single proceeding, including remedies such as seeking repossession of collateral and obtaining a money judgment against the borrower or any guarantor. Note that some states have statutes with respect to election of remedies. In those states, the lender may be limited to pursuing one type of action (for example, foreclosure) and may lose its rights to commence other actions. In such cases, the lender will need to determine which procedure would net the highest recovery. Below, we explore such remedies and the various considerations of which a lender should be aware in exercising such remedies.

Obtaining a money judgment. The lender may obtain a money judgment against the borrower and any guarantor by commencing a simple legal pro-

CCH a Wolters Kluwer business

ceeding. While the procedure for obtaining a money judgment may differ based upon the particular state rules, typically, proceedings based upon a failure to pay a defaulted and accelerated or matured loan provide an expedited treatment, and the lender may expeditiously proceed to obtain a judgment against the borrower and other parties obligated on the debt. Some states may allow defenses or counterclaims to be raised, which may derail an expedited judgment process. State laws may prohibit the lender from pursuing multiple actions against the borrower based upon the same debt instruments. In New York, for example, a lender may be required to proceed either with foreclosure or personal judgment proceedings.

Injunctive/prejudgment remedies. The lender can also proceed by obtaining prejudgment remedies, including obtaining a temporary restraining order or a preliminary injunction against the borrower in situations when the borrower may be attempting to sell or dispose of its assets below market value or otherwise divert or dispose of its assets or illegally transfer its property in order to prevent the lender from recovering the collateral. The lender's counsel can protect and thereby preserve the value of the collateral on an emergency basis with such remedies. The lender can obtain such remedy by way of an expedited proceeding known in many jurisdictions as an order to show cause, which is generally supported by a verified complaint laying out the factual basis for the lender's right to such prejudgment remedy. The order to show cause and temporary restraining order should also require that the borrower cooperate with the lender during the pendency of the lender's proceeding, including providing the lender with access to the collateral and the business records. This would allow the lender to inspect the books and records and thereby ascertain information about collection of the borrower's pledged accounts receivable or other income streams.

Note, however, that prejudgment remedies in the form of injunctions after a show-cause hearing are often difficult to obtain and may not prevent the dissipation of assets. Often, the hearing is scheduled long after the assets have been liquidated or transferred. The burden on the lender to show a need for an emergency hearing is often difficult to meet.

One state, Connecticut, appears to have dealt with the issue in a manner favorable to creditors. If the loan documents contain conspicuous language indicating that the borrower/guarantor in a commercial transaction knowingly and intentionally waives its rights to a hearing on a prejudgment remedy application, a prejudgment remedy such as a real estate attachment, a bank garnishment or an asset replevin may be obtained on the signature of lender's counsel prior to a hearing, so long as the borrower/guarantors are provided with notice and an opportunity to be heard immediately thereafter and the papers served on the parties meet certain statutory requirements including, but not limited to, allegations establishing probable cause that a judgment will be rendered in the creditor's favor.[2]

While RA9 provides effective and efficient procedures for a secured lender to realize upon its collateral, RA9 can also be a trap for the unwary.

Replevin

"Replevin" is non-RA9 judicial remedy by which a lender forecloses upon its security interest in personalty (non–real-estate collateral) granted under a security agreement. This type of action is typically instituted by way of an expedited proceeding known in many jurisdictions as an "order to show cause," which is supplemented with a verified complaint laying out the factual bases for the lender's right to replevy (recover) the collateral. The order to show cause would also be accompanied by an application for a temporary restraining order prohibiting the borrower from wasting or transferring the collateral during the pendency of the replevin action. The order to show cause and temporary restraining order may also require that the borrower cooperate with the lender during the pendency of the action to provide access to the collateral and the borrower's business records for purposes of inspecting and ascertaining information about collection of the borrower's pledged accounts receivable or other collateral.

CCH a Wolters Kluwer business

As replevin is an action that may deprive the borrower of its possession or use of the collateral, many jurisdictions require the creditor to post a bond in an amount that is a multiple of the collateral value. Often, a hearing on collateral valuation is required before the court will set the bond requirement. The purpose of the bond is to protect the borrower in the event the creditor does not prevail on its replevin claim and the borrower is damaged as a result of being temporarily deprived of possession or the use of the collateral.

If the lender proceeds with replevin and subsequent sale of the collateral, consideration must be given in advance as to how the collateral will be sold once the replevin is accomplished and the lender is in possession of the property. All nonjudicial secured-party sales of repossessed collateral must comply with the notice and commercial reasonableness requirements of RA9.

As a practical matter, the lender may not have the expertise to sell the type of goods or equipment that comprise the collateral and may thus need to retain an industry-savvy broker or auctioneer to conduct a public or private sale. With respect to the collection of replevied accounts receivable, if the lender does not have a factoring or other division accustomed to account collections, an agent may need to be retained to conduct such collections. In a case where the lender holds a guaranty from the principals of the borrower, the guarantors' cooperation in these collection efforts may well be forthcoming as they try to minimize their guaranty exposure.

The lender may not have a practical alternative to the replevin of collateral. In reality, however, the value of collateral at a distressed sale, further reduced by the costs of the sale process, often can be significantly less than the value of the collateral used in the ordinary course of the borrower's business on a going-concern basis. As a result, when pursuing a replevin, the maxim "be careful what you wish for" often applies. Depending upon the type of collateral involved, sale of assets by the borrower in a carefully restructured business-as-usual atmosphere will usually net a higher return. The question is, what is the cost of buying borrower and guarantor cooperation?

When pursuing a replevin, the maxim "be careful what you wish for" often applies.

Real Estate Foreclosure

A real estate foreclosure action in most states is a relatively straightforward process that allows the lender through a sheriff or other state official to sell real estate securing a loan free and clear of all liens junior in right to the mortgage or interest being foreclosed. In some states, however, for the lender to obtain title or sell the property, the lender must endure a foreclosure process that entails all-out litigation, including motion practice, discovery, potential borrower defenses and the possibility of a trial. As an alternative, a lender may attempt to negotiate a deed-in-lieu of foreclosure if there are no subordinate liens. The borrower will generally require a settlement on any deficiency and a release of any further liability before entering into an agreement to deed over the property to the lender. Lenders should also be mindful that any guarantor claims should be addressed at the same time in order to steer clear of any possible defenses guarantors may invoke for negotiating a settlement with the borrower without guarantor involvement.

As part of the real estate foreclosure process, a lender may be able to seek certain prejudgment equitable remedies, such as the appointment of a rent receiver to manage the property or the sale of the premises while the property is still in foreclosure (a/k/a a sale pendente lite) if such remedies are supported by the facts. It is important to keep in mind, however, that often a prejudgment remedy in foreclosure will require the lender or its agent to post a bond and bear all of the costs associated with the requested relief. Finally, the recovery of litigation expenses in foreclosure proceedings (attorney fees, hard costs and associated expenses) may be limited or capped by statute or court order. Indeed, in some jurisdictions the very availability of a foreclosure remedy is limited by "election of remedies statutes," whereby the lender must decide at the outset as to whether it will seek to obtain a money judgment against the borrower (in personam) or proceed with a foreclosure action against real estate assets (in rem).

CCH a Wolters Kluwer business

Receivership

In certain circumstances, a state or federal court receivership may be a better alternative to precipitating a bankruptcy filing. There are advantages and disadvantages of proceeding with a state or federal court receivership. For one, in most jurisdictions, receivership law is not a well-developed body of law. A notable exception is Rhode Island, where state court receiverships are a significant cottage industry. At the same time, however, a receivership actually provides additional flexibility not offered by well-established law. It may also provide the ability to narrowly tailor relief to particular assets and/or a particular business, which may otherwise be unavailable under bankruptcy law. The creditor also has broad discretion to propose the receiver. One significant consideration, depending on the federal or state court where the action is brought, is the ability or inability of a receiver to sell assets free and clear of liens, claims, security interest and other encumbrances.

There are two types of receiverships: a general (or liquidating) receiver and a special receiver. The general receiver is similar to a bankruptcy trustee, while the special receiver typically only takes possession of certain designated assets or businesses and operates or sells same, leaving the rest in the borrower's possession. Federal receiverships are especially useful when assets are located in more than one jurisdiction. To access a federal receivership, the lender must satisfy the federal subject matter jurisdiction requirements, which require diversity and a minimum dollar amount in controversy (as federal question jurisdiction is generally not applicable to creditor's rights actions).

State court receiverships are authorized under certain specific circumstances, including but not limited to waste or material injury to property of the debtor, insolvency, fraud or mismanagement of corporate assets. Many states also provide for appointment of a receiver on general equitable principles regardless of whether the debtor is insolvent or solvent.

There are certain advantages to seeking a receivership, including the ability of a single creditor to seek appointment as opposed to involuntary bankruptcy proceedings, where multiple creditors are required. In addition, a party seeking a receiver is able to quickly insert an experienced manager by proposing a list of possible receivers for selection by the court. In addition, when compared to bankruptcy, there are fewer procedural rules and statutory regulations resulting in greater flexibility. In situations where a special receiver is used, the receiver can focus on certain assets and/or businesses, while leaving the existing management in place to operate other businesses and assets.

CCH
a Wolters Kluwer business

Assignments for the Benefit of Creditors

Another potential option is to proceed with an assignment for the benefit of creditors. This asset liquidation process is generally nonjudicial and involves a transfer of both legal and equitable title to all the borrower's property to an assignee who has the authority to liquidate the borrower's assets and distribute the proceeds equitably to the borrower's creditors. Some states like New York, however, have statutory requirements for judicial oversight of an assignment proceeding. An assignment of this nature is generally created and governed by statutory authority and common law. The lender and its counsel will need to determine the requirements in the state in which the borrower and its assets are located. This option should only be considered in situations where there is no possibility of a turnaround or restructuring, and liquidation is the only viable option.

There are certain advantages in proceeding with such action. The personal liability of directors and officers for running an insolvent borrower ceases to be an issue once the assignment occurs. In addition, asset sales can occur quickly, thereby commanding a higher sale price. Also, the assignee can maintain limited operations of the borrower, which can maximize the remaining value of the borrower's assets. Finally, certain contractual obligations can be negotiated and resolved efficiently by the assignee, whereas existing management of the borrower may have been at loggerheads with its creditors.

In New York, for example, the assignor/borrower must file such assignment with the county clerk in the county where the principal place of business is located. Such assignment must be in writing and include the address and type of business of the as-

signor/borrower. The assignor/borrower must file a schedule of assets and a list of creditors with the county clerk and the assignee within 20 days of the assignment. In addition, the assignor/borrower must deliver books and records to the assignee. The assignee is able to review, control, clean up and work toward closure of the corporate situation before and during the sale of assets. Thereafter, the assignee must (1) post bond to the state in an amount ordered by the court; (2) give notice to all creditors of proposed sale of property, payment of dividends, filing of an interim report and filing of a final report; (3) file a list of creditor claims with the court and make appraisals of the property; (4) sell property of the estate; (5) file an interim report with the court six months after the assignment unless property has already been sold and the proceeds distributed; (6) file a final report with the court; (7) pay dividends; and (8) close the assignor/borrower's estate. Any sale must occur at a public auction unless otherwise authorized by the court.

The court also has the following rights in connection with the administration of such procedure: (1) upon a showing of cause, remove the assignee and appoint another; (2) authorize the assignee to continue the assignor's business; (3) allow or disallow claims; (4) direct distributions of any dividend; (5) authorize private sales of the estate; (6) require further security in the event that the assignee's bond is not adequate; and (7) authorize creditors to present claims to the assignee by a specified date advertised in a newspaper. All creditors are required to present claims within six months of such assignment. In addition, the assignee must notify creditors by mail at least 10 days prior to any sale of the assets of the estate. Before paying any creditors, the assignee must pay (1) employees any amounts contributed to retirement plans (plus interest); (2) wages for any services rendered up to two months prior to the assignment (up to $1,000 per entity); and (3) for the purchase of any merchandise purchased within six months of the assignment (up to a maximum of $300).

From a legal perspective, trust law generally governs any assignments for the benefit of creditors. The assignee is considered a trustee, and its duties and responsibilities to the borrower's creditors are the same as a trustee's duties to the beneficiaries of a trust. The operative assignment document authorizes the assignee to liquidate the borrower's property in satisfaction of the creditors' claims against the borrower on a timely basis. Under common law, this was the assignee's chief function. Even if the assignment document does not expressly empower an assignee to sell the property, the assignee still has the power to do so in order to pay the creditors.

Liability Considerations

Lenders should carefully analyze the potential consequences of initiating various enforcement options in order to minimize potential liability risks in connection with undertaking enforcement actions. Factors to analyze should include, but certainly are not limited to the following:

- Whether the lender should take title to the collateral and the risks associated with taking title
- Whether there are other creditors who hold senior or subordinate claims with respect to the collateral and the necessity of properly notifying such parties in connection with litigation or other nonjudicial enforcement actions
- The need to analyze actions with respect to certain equipment and machinery that may be on lease to the borrower by equipment financing companies or equipment manufacturers
- Whether any significant course-of-conduct or equitable subordination issues have been detected during the preenforcement review of the legal and credit files

Further, in connection with a foreclosure of real property or a deed in lieu of foreclosure, the lender may be faced with a host of potential issues, ranging from environmental, zoning, subdivision or title defect issues to whether there exists a market for the sale or rental of the property. Postforeclosure or deed in lieu, the lender will have the responsibilities of an owner, including providing for insurance, payment of taxes and utilities and the cost for general maintenance. In certain circumstances where the borrower has limited funds, the lender may take on many of these responsibilities before obtaining title for the sole purpose of maintaining collateral value. In the event that the sale process has commenced but (as is usually the case) is delayed, the carrying costs of preserving the value of the real property collateral can mount quickly.

For these reasons, many lenders set up separate subsidiaries or affiliates to act as the entity that

CCH a Wolters Kluwer business

will ultimately hold title to real property through an assignment of the lender's rights under the loan documents so the parent lender never succeeds to the obligations imposed upon a fee owner of the property. Another viable approach, where a third-party buyer is known, is for the lender or its subsidiary entity to assign its right to bid at the foreclosure sale to the ultimate buyer of the property. The result is that neither the lender nor the foreclosing entity is in the chain of title. This assumes, of course, that a purchaser for the property is located before the sale.

The last point raises another practical consideration that must be weighed when the decision to foreclose is made: Is there a buyer willing to pay a price approaching the lender's conception of market value? In many instances, a ready market exists and this consideration is of minimal concern. The foreclosing lender, however, must weigh the real possibility that a market may not exist and that the lender may well hold title to the property for an extended period of time until market conditions improve. A related issue arises from the fact that the borrower may be entitled to a fair-market-value credit in a subsequent suit seeking recovery from the borrower or guarantor for a deficiency on the note. That fair-market-value credit, typically determined at a hearing before a court, may far exceed what the foreclosing entity may actually realize from the sale of the property under distressed circumstances. This would substantially reduce the amount of the money judgment that the lender can obtain against the borrower and the guarantors. While there may not be a practicable way to avoid this result, the potential impact of this reality must be analyzed when the lender is considering the foreclosure option.

The lender should also be aware that the borrower may seek to commence an action against the lender for any actions the lender has taken in connection with the collection and enforcement of its rights with respect to the collateral. Certainly there are times when a lender should be concerned. Under most circumstances, however, if the lender has acted in a commercially reasonable manner (and that can include exercising aggressive enforcement provisions contractually agreed upon in the credit agreement), defenses or affirmative lender liability claims ultimately will not prevail. Lenders should seek advice of counsel to assist in the analysis of these defenses and claims. Most often these claims and defenses are recognized for what they really are: an effort to forestall the inevitable; an effort to force the lender to spend large, potentially unrecoverable sums on legal fees; and an effort to force the lender to a negotiated settlement.

Tap the Full Scope of Remedies

Understanding the full scope of enforcement remedies available (contractual, statutory and judicial) under the specific circumstances presented will enable a lender to intelligently select the course of action best suited to achieve the lender's loan recovery goals.

© CCH a Wolters Kluwer business

Endnotes

* This article is designed only to give general information on the topics actually covered. It is not intended to provide legal advice or render a legal opinion. The views expressed herein are those of the authors and do not necessarily reflect the views of Proskauer Rose LLP or of CapitalSource Finance LLC.

1 This article is the authors' second in a two-part series for commercial lenders who want to be proactive when faced with a credit exhibiting signs of financial distress. The first was *Preparation: The Key to Enhancing Distressed Debt Recovery Opportunities*, Commercial Lending Rev., Jan.–Feb. 2007), at 18.

2 *See* Connecticut General Statutes §52-278f.

This article is reprinted with the publisher's permission from the Commercial Lending Review, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Commercial Lending Review or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All rights reserved.