New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An incisivemedia publication

REAL ESTATE & Title Insurance Trends

WWW.NYLJ.COM

MONDAY, AUGUST 24, 2009

Pre-Workout Agreements Are Today's Lender **Essentials**

Put their protection in place before beginning borrower negotiations.

BY DAVID M. STEWART AND ELIZABETH JAFFE

HOW CAN a real estate-secured lender, faced with increasing defaults by borrowers and falling property values, protect itself during borrower negotiations pursuing a restructuring, or "workout," of the loan?

In the recent real estate downturn, lenders increasingly find themselves faced with defaults, or imminent defaults, by their borrowers. The defaults may be caused by decreasing cash flows generated by the properties as a result of the general national economic conditions (e.g., retail centers and hotels), may be caused by the tightening of the credit markets and borrowers' inability to refinance their loans, many of which include a significant balloon payment upon maturity, or may be caused simply by borrower mismanagement of the underlying asset and its cash flows.

To make matters more complex, lenders today may find that foreclosing on the mortgaged property is not the best defaulted loan strategy: Due to decreased property values and a lack of willing purchasers, the lender could still face a significant shortfall in the recovery of its loan, even if the property could be sold at foreclosure.

Many lenders (not to mention property owners and developers) may view a loan extension as the best option to obtain the greatest principal repayment, by waiting out the current environment and hopefully benefiting from a future economic turnaround. In comparison to pursuit of foreclosure or other loan remedies, workouts may avoid the need for balance sheet write-downs, and often just make sense, both in terms of time efficiency and in realizing the greatest possible return on the lender's investment.

However, extending the loan, or agreeing to any other type of restructuring in an environment that is vastly different from when the loan was originated, requires the parties to alter, sometimes significantly, the bargained-for deal made at the time of the loan's origination. In order to successfully restructure, the lender and borrower need

DAVID M. STEWART *is a partner, and* ELIZABETH JAFFE *is an associate, in the New York office of Latham & Watkins.*

ISTOCK

to hold discussions, correspondence and negotiations, even while the existing loan remains distressed and perhaps already in default.

An effective pre-workout or pre-negotiation agreement between the lender and borrower can ease that process.

What does today's pre-workout agreement need to accomplish? At a minimum, a successful pre-workout agreement must maintain the status quo of the lender and the borrower during the workout discussions.

The essence of the pre-workout agreement is that the lender may consider and discuss with the borrower revising the loan terms, or renewing or extending the loan, without in any way prejudicing the rights the lender has already gained or will gain by virtue of the borrower's default, in the event the lender and borrower are unable to reach a definitive agreement to restructure the loan.

The Two Big Mistakes

The biggest mistake lenders make with respect to pre-workout agreements is not having them.

Some lenders fall into the trap of failing to put a pre-workout agreement in place simply because they could not anticipate a borrower default, or because the lender thought it could pursue its remedies or bully the borrower without a pre-workout agreement. In other cases, the lack of a pre-workout agreement results from a relationship between the borrower and the lender that is so troubled that the parties cannot even come to terms on the text of such an agreement.

However, regardless of the reason for not entering into a binding pre-workout agreement, in the absence of one, the lender runs the risk that its oral or written statements will be construed as default waivers on its part, or as a promise or acceptance of restructuring terms.

The biggest mistake lenders make in negotiating pre-workout agreements is being too tough on their borrowers.

Some lenders send borrowers a pre-workout agreement that tries to be comprehensive, a document that attempts not just to preserve the lender's rights, but also to strengthen them. Typically, the borrower will protest vociferously, and the lender and borrower may never finalize the agreement. In the meantime, the fruitless effort and time spent negotiating the unsigned pre-workout agreement runs in favor of the borrower, which ends up with a de facto waiver of its default during the time wasted on spurious negotiations. And as time progresses, the borrower gets a stronger and stronger argument that the lender has waived the borrower's defaults.

What Lenders Really Need

For this reason, lenders need to know their bottom line requirements for any pre-workout agreement, and need to finalize an agreement quickly. Here's what lenders really need:

• ***Avoid being bound inadvertently.*** The lender must know that it will not be bound by any possible oral agreements, correspondence, term sheets and draft agreements until the parties have come to a definitive agreement and both the lender and the borrower have signed a document memorializing their understanding. If the parties reach an interim understanding on a sub-issue but do not come to agreement on the overall terms of the loan restructuring, then the parties should not be bound by that agreement on the sub-issue, unless they mutually agree that the sub-agreement is acceptable in itself, and the parties formalize it in a written agreement.

To try to assure that discussions, letters, term sheets and drafts don't find their way into court, the pre-workout agreement should include a statement that all actions going forward will be in the nature of settlement discussions, and therefore will not be admissible as evidence in court or in arbitration, and that none of these materials can be construed as an admission by either party. Then, to be safe, when corresponding or meeting with the other side, each party should note at the outset that the discussions or written materials are subject to the pre-workout agreement.

• ***Don't waive existing rights.*** Every pre-workout agreement should contain a statement that explicitly preserves the status quo under the terms of the loan documents. The pre-workout agreement should confirm the parties' understanding that all negotiations or discussions undertaken pursuant to the pre-workout agreement will not constitute a waiver of any borrower defaults or of the lender's rights and remedies under the loan documents (and, in fact, the pre-workout agreement should expressly reserve such rights, especially when a default already exists).

The lender will in most cases want to keep the clock ticking against the borrower during the workout discussions. For this purpose, the pre-workout agreement may say that any default notices previously delivered remain in effect, and that the workout discussions will not toll, suspend or extend any borrower cure periods, notice periods or other time periods under the loan documents and applicable law.

Of course, many borrowers will be offended by the possibility that the lender could pursue its foreclosure or other remedies at the same time as the parties undertake the workout negotiations. The borrower may instead ask for a limited "standstill" period during which the lender will agree to suspend its enforcement actions. In considering whether to accept such an agreed deferral period, the lender must balance its need for speedy realization on its collateral against the likelihood and timing of an acceptable restructuring with the borrower.

• ***Leave the door open.*** The lender needs to be able to call it quits at any time. At some point, either of the parties may reach the decision that the discussions are simply not progressing, or that the value of pulling the plug on the loan is greater than the possible upside of consummating a restructuring. Therefore, either party should be able to call off the discussions at any time, simply by sending the other party a notice to that effect.

The pre-workout agreement must make it clear that either party has this right. An open-ended pre-workout agreement, with no explicit right to terminate the talk, may be worse than no agreement at all, because the workout discussions may establish a waiver, a "course of dealing," or an implication that the parties had made some kind of commitment, even though unwritten, to reach an agreement.

The pre-workout agreement should allow the parties to terminate with or without offering any justification to the other side. Of course, some cases in some jurisdictions imply a lender duty to negotiate in good faith. No one can guarantee that an explicit termination right in the pre-workout agreement would overcome that implied duty of good faith.

> The essence of the pre-workout agreement is that the lender **may consider** and **discuss** with the borrower revising the loan terms, or renewing or extending the loan, **without** in any way **prejudicing** the **rights** the lender has **already gained** or will gain by virtue of the borrower's default.

• ***Make it clear who pays.*** Some loan agreements require the borrower to pay all of the lender's costs of administering the loan; other loan agreements require the borrower to pay for the lender's costs of enforcement, only; still others are silent on costs, relying instead on the initial commitment letter.

If the workout discussions are an accommodation to the borrower, then the lender should attempt in the pre-workout agreement to require the borrower to pay the third-party costs (including legal fees) of those discussions, even if the parties don't eventually reach agreement on a restructuring, and even if it is the lender who ultimately withdraws from the discussions. Where the lender has leverage, it may even require the borrower to make an advance payment in respect of those expected costs. This payment is akin to an application fee. If the lender doesn't require that advance payment, then any promise by the borrower to pay the lender's costs may be of minimal value.

In instances where the lender has little leverage, if the loan is not in default or there is little pressure to restructure, the parties may agree to pay their own costs of negotiating the workout. Of course, under those circumstances, if the parties eventually finalize a deal, the lender could require payment of its legal fees as a precondition to the effectiveness of the definitive restructuring agreement.

• ***Pre-workout agreement as estoppel.*** In today's environment, a lender with negotiating strength may reasonably conclude that these minimum requirements are still not enough to bring it to the bargaining table. When a loan is in default, the lender-borrower relationship has been tense or uneasy, or the borrower has previously alleged that the lender may be in default or may be susceptible to lender liability, then the lender may want a pre-workout agreement that also functions much as an estoppel certificate against the borrower. Therefore, the lender may ask the borrower to acknowledge irrevocably in the pre-workout agreement the following items:

– a reaffirmation of all of the borrower's obligations under the loan documents in favor of lender;

– an acknowledgment that all the loan documents remain in full force and effect in accordance with their terms, and will remain in force until the parties have reached a definitive restructuring agreement;

– an acknowledgment that the loan is fully funded and the lender has no further duty to make advances or perform any other affirmative obligations;

– a statement that the borrower has no defenses to repayment of the loan and, ideally, that the borrower has no offsets, abatements or other defenses under any of the loan documents; and

– an acknowledgment that the lender is not in default or liable to the borrower.

This last acknowledgment is particularly valuable if the borrower has previously alleged that the lender has not acted in good faith, or if disputes have already arisen during administration of the loan. Some pre-workout agreements go further, making a detailed, explicit release of all lender liability a precondition to entering into the workout negotiations.

How Demanding Should Lenders Be?

At some point, even the most minimally advised borrower will refuse to sign a pre-workout agreement with provisions like those suggested above. The borrower will say that signing such an agreement has the opposite of the intended effect: Instead of preserving the status quo and maintaining each party's existing rights, such an agreement effectively requires the borrower to give up some of its rights, and to weaken its position, against the lender.

If the borrower balks, the lender must reevaluate its goals for the pre-workout agreement. Lenders should always appear tough, firm and decisive. Ultimately, though, lenders should be prepared to concede points on this language. Remember, even if the lender does not obtain these waivers and assurances in the pre-workout agreement, it will still have a chance to (and should) negotiate them into the definitive restructuring agreement.