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Cleaning Up Bad Boilerplate in a Loan Workout Agreement

As the recession continues, we have been seeing more and more workout agreements between owners of commercial real estate and their mortgage lenders.

Workout agreements are drafted by the lender. The first draft is always heavily one-sided. The business terms of the workout agreement may be presented as non-negotiable, and only by pushing back can the borrower find out if this is indeed the case.

Even when the lender is unwilling to negotiate business terms, the persistent borrower may find wiggle-room to negotiating "standard," or "boilerplate," clauses. These clauses may cause the borrower's eyes to glaze over, but they can have a significant effect on the borrower's ability to continue to stay in business.

In this e-alert, we discuss four common boilerplate clauses that often need to be cleaned up.

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Clause Granting the Lender the Right to Take a Deed in Lieu of Foreclosure, Plus a Deficiency Judgment

Typical clause: "Borrower is depositing with Lender on this date a deed in lieu of foreclosure transferring title to the mortgaged property from Borrower to Lender. Upon an event of default under the terms of the Loan Documents, or under this Agreement, Lender may record the deed in lieu of foreclosure in which case all right, title and interest in and to the mortgaged property shall be thereafter held by Lender. Borrower understands, acknowledges and agrees that such delivery and recording of the deed in lieu of foreclosure shall not in any manner constitute a waiver by Lender of its right to seek a deficiency judgment against the Borrower."

What's wrong with this clause:

- There's no way to compute the amount of the deficiency judgment.
  - Suppose the lender holds the property for three years after receiving the

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deed, during which time commercial property values continue to decline, and the lender's poor management devalues the property even further. The borrower should not be held responsible for the additional loss.

  - Arguably, the deficiency judgment should be limited to the amount by which the loan balance exceeded the property's market value on the date the lender recorded the deed.

- Without a deadline by which the lender must sell the property, the possibility of a deficiency judgment looms over the borrower indefinitely.

How to fix the deed in lieu/deficiency clause:

  - Provide that the borrower's liability for a deficiency expires if the property is not sold by a specified deadline (such as one year from the date the deed in lieu of foreclosure is recorded).
  - Failing that, try to require that the lender use good faith, commercially reasonable efforts to sell the property by the specified deadline.

The Cross-Collateralization/Cross-Default Clause

Typical clause: "Upon execution of this agreement, all notes and guaranties, including but not limited to all extensions, renewals, replacements thereof, and all future loans to the Borrower, are secured by all of the collateral now securing this loan. Furthermore, any default under any of such notes and guaranties shall constitute a default under this loan, and any default under this loan shall constitute a default under such notes and guaranties."

What's wrong with this clause:

- A default under any other loan extended to any of the borrower's other projects would put this loan into default. Thus, the borrower's entire portfolio of loans with the lender will go into default even if only one of those loans is in default.
- If loans extended by the lender on other projects have secondary financing provided by another lender, this clause could trigger a default under the secondary financing. The reason is that a cross-default clause effectively increases the principal amount secured by the first mortgage to the combined

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principal amounts of all of the primary lender's loans to the borrower.

- If "Borrower" is defined to include parties besides the owner of the mortgaged property (such as the borrower's parent, subsidiaries, affiliates and guarantors), this will destabilize the financial condition of the other parties.
- If "Borrower" is defined to include different entities controlled by a common manager but with different investors, this clause may result in commingling of the various entities' assets, leading to a breach of fiduciary duty by the common manager.

How to fix the cross-collateralization/cross-default clause:

- Delete it.
- Limit the definition of "Borrower" to the owner of the mortgaged property securing the loan in question.
- Limit the other debt for which the mortgaged property will serve as collateral to specific, existing loans that should then be identified by loan number or by original principal amounts and dates.
- If multiple entities that are parties to the agreement have the same manager, the manager should check each entity's organizational documents to determine whether member consent is necessary and, if it is, obtain the necessary consents.

The Higher Interest Rate Clause

Typical clause: "Interest on the unpaid balance of the Note shall, beginning on the date of this Agreement and continuing through the maturity date, be increased to ________% per annum."

By the time the workout agreement is negotiated, the borrower is already in default. Generally, the default arises due to the borrower's failing to make loan or tax payments, or to meet financial covenants. Lenders understandably justify increasing the interest rate because of these past defaults.

What's wrong with this clause:

If the borrower couldn't keep up payments at the old interest rate, increasing the

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interest rate may make continued defaults inevitable.

How to fix the higher interest rate clause:

- Delete it.
- Adjust the payment schedule so that even if the interest rate is increased, the borrower has a realistic chance of making the new note payments. This can be done by:
  - using a longer amortization period,
  - deferring a portion of the interest and adding it to unpaid principal, or
  - changing the payment schedule from amortizing payments to interest-only payments.
- Provide that when the borrower cures the defaults that prompted the workout agreement, the pre-workout interest rate and payment schedule will be restored.

Limitation on Expenditures by Borrower

Typical clause: "Borrower shall not transfer any of its assets in excess of $25,000 in the aggregate in any calendar year without receiving fair cash consideration."

What's wrong with this clause:

- Often, nothing. If "Borrower" is a single-asset entity with no assets other than the mortgaged property, this clause may be necessary to avoid waste.
- If, however, "Borrower" owns other properties and business interests, or if "Borrower" is defined to include parties besides the owner of the mortgaged property (such as the borrower's parent, subsidiaries, affiliates and guarantors), this clause may be very onerous. This is because the borrower's "assets" include its bank accounts.
  - A borrower that owns other properties may be precluded from spending money to make necessary expenditures for necessary maintenance, repairs, and replacements to those properties.
  - An individual guarantor may be precluded from spending money for holiday

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gifts, a child's education, or day-to-day living expenses.

How to fix this clause:

- Limit this clause to transfers of assets that have been given as security for the note.
- Create carve-outs for specified anticipated expenses.
- Increase the cap on permitted expenditures to a reasonable level.

Please contact Jesse Ishikawa at 608-229-2208 or your Reinhart attorney if you have any questions on loan workout agreements.

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