Troubled Asset Resolution

Course 2039/3039

J. Michael Allen

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TROUBLED ASSET RESOLUTION

J. Michael Allen
EVP, Director of Real Estate Credit Risk
Cadence Bank, N.A.
Atlanta, GA
Atlanta office: 404-266-4501
Gainesville office: 404-239-8755
James.allen@cadencebank.com
COURSE OUTLINE

Session 1:

Introduction and Course Overview
- 99.8% - what does it mean?
- Three Leg Stool: growth – profitability – quality
  - How do they compete?
- Lend cash - get repaid with cash!
- Approach a problem systematically and analytically.
- Do not react - be proactive.
- Maintain control.
- Act to minimize risk of further loss.
- What do I do if and when I get sued?
- Three possible outcomes:
  - Fix it;
  - Move it - the Greater Fool Approach;
  - Liquidate it.
- Importance of Your Bank's Capital Position.....i.e. “The Pill”

Manage the Work-Out Effort
- Recognize the problem (head in the sand)
- Give me the best you have who you do not mind losing
- Choosing the right attorney.... It matters!
- Responsible party “expert” or originating officer
- Failure to act is management malfeasance
- Time commitment and effect on your calendar

Five practical workout steps and tips
1. Find a default trigger
   a. Loan maturity
   b. Payment default
   c. Covenant violation
2. Make a formal demand for payment ASAP
3. Take steps to find and to garnishee assets and/or sue for judgment
4. If you agree to waive default or re-set the loan:
   a. Use a forbearance agreement
   b. Include “waiver of claims” clause to hold harmless the bank
   c. Get additional collateral or guarantor support
5. Don’t cave in to a threat of bankruptcy
What is your Institution’s Credit Culture? Is it:
- Relationship Driven
- Policy Governed
- Do You Know Your Customer?
- Cash Flow Focused
- Pro-Active Ownership of Customers
- Healthy Skepticism
- Are Actions governed by Your Company’s Values?

Five Stages Bankers Experience in Dealing with Problem Loans
- Denial
- Anger
- Bargaining
- Depression
- Acceptance

How do you lend money?
- How does the customer make money
- Use of your proceeds
- How will you get paid back?
- What are the risks to repayment
- Have I mitigated the repayment risks?

Why Loans Go Bad
- Identify the problem and its root cause(s)
- Develop a game plan

Impairment Testing
- Collateral dependent or not
- What’s the difference?
- Confirmed Loss
- OREO Impairment Assessment – AV vs. regulatory net present value approach

Special Legal Considerations
- Business judgement rule – what is it in my state?
- Business Courts- what are they and does my state have them?

Regulatory Observations/Areas of Focus
- Cyber Security
- Liquidity
- Concentrations
Session 2:

Remember - The debtor knows more than you!

Diagnosing Operating/Management Problems
- Does management have a plan?
  - Be skeptical
- Never meets projections
- Capital withdrawals/dividend payments
- Poor financial controls
- Change in personal habits
- Too many mouths to feed
- Taking the eyes off the ball

Decision Tree
- Can they pay?
- Will they pay!
- Can they be made to pay?

What are the “troubled” signs to look for?
- Request for restructure
- Collateral over advances
- Overdrafts
- Late Payments
- Tax problems - payroll taxes paid?
- Conversion of trade debt to notes payable
- Rapid growth in plant and equipment
- Mismatched asset financing
- No strategic plan or direction
- High personnel turnover
- Frequent accountant changes
- Evasiveness of borrower
- Non-compliance of loan agreement terms

Analyzing the Problem Loan - a Nine Step Process:
1. Documentation Review - What are you looking for? Do I tell all?
2. New lien search and collateral valuation - true liquidated value
3. Financial analysis
4. Related family debt search - why is this important?
5. Evaluate operational problems
6. Evaluate financial problems
7. Are there environmental concerns?
8. Can this borrower survive?
9. Decide what your plan is and execute
Tools to help you analyze the problem:
- Site visit
- Peer analysis
- Turnaround or management consultant
- Breakeven analysis/sensitivity analysis
- Seek input from experienced lender

Potential “least cost” Resolution Strategies to Consider:
- Settle
  - Note
  - Cash
  - Collateral
- Litigate
  - Judgment award
  - Consent judgment
- Foreclose
- Sell Note

1099-C Considerations

Focus:
- The goal? Return OF my investment and not ON my investment!

Your weapons:
- Venue - your place or theirs?
- Pricing
- Amount
- Collateral
- Short term maturities
- Forbearance Agreements
  - Opportunity to correct document deficiencies
  - Acknowledgement of debt by debtor and guarantors
  - Release of lender liability claims
  - Payments on the note
  - Payment of forbearance fee
  - Pledge of additional collateral
  - Board approval or not

Workout Negotiations
- Is a workout the better path or is it better to liquidate?
- Pre-work out letter
- No agreements until put in writing
- Go into negotiations with eyes open
- No guarantees of a happy ending
- Select the advisors of your choice
Session 3:

Special Concerns

Collection Process
- Do I sue on the note (exercise my collateral rights) or go after the gytor first?
  - Filing a claim
  - Answer period
  - Discovery
  - Trial or default judgment
  - Judgment
  - Giving Notice – suggested lettering

Arbitration, Mediation, and Litigation
- Privacy
- Cost
- Time to judgment
- Discovery period
- Limits on appeal

Miscellaneous Considerations:
- Documentation flaws - can I fix them and in time?
- Relationship history - "course of dealing" - How am I handling overdrafts?
- Other creditors
- Can I improve my position? Good money after bad.
- Environmental consideration
  - Identify the responsible party
  - How do I avoid becoming a "responsible party"?
- Lender Liability Risks – Is there a basis for a claim?
  - Promising future or additional financing
  - Good faith and fair dealing - ethics
  - Am I obligated to additional financing
  - Control and interference
  - Breach of Fiduciary Duty
  - Fraud
  - Exercise caution in documentation – especially memos and emails
  - Is there anything that I should be afraid of (You do not know what you do not know!!!!)?
  - Use the sixth "C" – Common Sense
- Participation Risk(s)
- Collusion risk
Guaranties

- Payment or Collection?
- Guarantor vs. Co-Borrower
- Secured or unsecured?
- Guarantor Defenses:
  - Release of principal guarantor
  - Release of co-guarantor
  - Non-disclosure of material information
  - Failure to obtain signatures
  - Change in terms and proper disclosure
  - Lender fails to follow loan agreement
  - Lender fails to dispose of collateral in commercially reasonable manner
- Structure of Credit and Drafting Issues
- Guaranty Enforcement Issues
- Statute of Frauds and Alleged "Oral Agreements"

Collecting SBA Loans

- 504 Loans
  - Will SBA enter a protective bid – formula
  - Right of Redemption – what is it and how it affects settlement
- 7-A loan guarantees
  - Caution – bank actions may void the guarantee
  - Bank generally exhaust all collection efforts first before SBA
  - Collection plan of guarantee is not automatic

Foreclosure Consideration

- Two Types of Foreclosure
  - Judicial – court action (i.e., mortgage situation)
  - Non-Judicial – outside court, common in Deed of Trust states
- Real Property
  - Advertisement
  - Sale on the courthouse steps
  - Chilling the bid
  - Confirmation and deficiency judgments
- Personal Property
  - Together with real property or separately
  - Repossession
  - Breach of the peace
  - Notice
  - Sale
- Deed in lieu of foreclosure
  - What is it?
  - Risk to lender
- Protect or Not Protect
- Your obligation to be “aware” and informed
OREO Considerations and Challenges

Pre-foreclosure analysis
Appraisals
Insurance
Legal
Taking ownership
- Property tax payments
- Day of sale
- Establishing bid
- Secure property
- Photos
- Prepare to market property
- Expenses – maintenance, finish, etc.

Marketing
- Retail
- Bulk
- Auction
- Choosing the best realtor

Property Tax Appeal Process

Sale of Troubled Loans
- All loans have some value
- Buyers may be individuals, institutions, guarantors
- Hold an auction
- Sell one loan or the portfolio
Session 4:

THE BASICS OF BANKRUPTCY

- Primary goals of U. S. Bankruptcy Code
  - Protection of the insolvent debtor
  - Preservation of asset values for creditors
  - Promote equality of asset distribution among creditors of the same class (generally two classes: secured and unsecured)

- Six Types Based on Action Taken
  - **Chapter 7** – “straight bankruptcy”
    - Liquidation handled by an appointed trustee
    - Individuals, corporations, partnerships
  - **Chapter 9** – Works like an 11 only exclusive to municipalities
  - **Chapter 13** – reorganization
    - Limited in size (amount of debt)
    - Individuals and proprietorships only
  - **Chapter 11** - reorganization
    - No size (amount of debt) limit
      - Debtor gets 120 days to file a plan; however, extensions can be sought and usually are granted
      - Creditors can file objections to the plan after 120-day (or as extended) period granted to debtor
      - Key issue for banks – notice the amount of time that is elapsing, while you are stuck with a non-performing asset
    - Individuals, corporations, partnerships
    - If corporation/partnership, called debtor in possession
      - No trustee appointed initially, but can be requested later
  - **Chapter 12** – Family Farmer/Fisherman

- **Chapter 15** – Allows court to be involved in bankruptcy involving multiple countries – typically attached to a bankruptcy claim by a debtor in a foreign country.
- **Two Types by Who Filed**
  - Voluntary – debtor initiated
  - Involuntary – creditor initiated
    - Grounds for filing
    - What type claims are valid?
    - Bona fide dispute
    - How many creditors does it take to file an involuntary case?
    - Adding claimants
    - Generally not paying debts as they come due
    - Damages against creditors if petition is dismissed

- **Procedural Matters and would the lender be better off with the debtor in bankruptcy?**
  - **Automatic Stay** provision serves two of the primary goals of the U.S. Bankruptcy Code
    - Injunction that restricts creditors from contacting the debtor
    - Prohibits setoff, other judicial proceedings, enforcement of liens
  - **Notice** of the bankruptcy filing is sent to all known creditors of the debtor and establishes the *automatic stay*
  - **Proof of Claim** is another document sent by the court to the creditors and must be completed (filled out) and filed with the court by a certain deadline; do this even if you know your claim is unsecured
  - **341 Hearing** is the first meeting of creditors, and may be only chance to question the debtor under oath (get legal counsel involved)

- **Priority Claim**
  - Who gets paid first
• **Preference Period**
  
  ▪ **Preferences – basic elements**
    
    o Transfer of property of the debtor prior to filing
    
    o At a time when debtor was balance-sheet insolvent
    
    o Effect is to increase the amount transferee (recipient) would receive in a hypothetical Chapter 7 (liquidation) case. That is, to prefer the transferee over other creditors in this class.
    
    o Issues for banks
      
      ♦ Examine payments to you and collateral obtained in the 90-day window
      
      ♦ Examine debtor’s dealings with other creditor that may have preferred them over your bank
    
  ▪ **Fraudulent conveyances**
    
    o Transfers of assets or other actions made by debtor, prior to petition, with the intent to hinder, delay or defraud creditors
    
    o Can be reversed or recovered by the court
    
    o Protections for good faith purchaser, whereby it can retain a lien if deemed “innocent” and value was exchanged
  
  ▪ **Lift of Stay or Relief from Stay**
    
    o Court ruling where a secured creditor can go ahead and recover collateral, even if bankruptcy case has not been discharged
    
    o Secured creditor argues
      
      ♦ There is no equity in the collateral, or the value of the asset does not exceed the secured creditor’s claim
      
      ♦ Lack of adequate protection of the interest in the property, such as forwarding of rent payments
◆ Property is not necessary to an effective reorganization
  ○ If equity exists (and other creditors may argue this point)

◆ Court or trustee not likely to agree to a lift of stay, since the equity represents excess dollars to be potentially distributed to unsecured creditors

◆ However, secured creditor is entitled to adequate protection payments so that interest in collateral does not dissipate; payment amount is negotiated between debtor and secured creditor, then approved by the court
  ○ If equity does not exist

◆ Court or trustee likely to approve lift of stay

◆ Take steps to recover or liquidate the asset
  ♦ If your recovery falls short and leaves a deficiency (sale price is less than amount owed to you), you cannot go back to the court and get a deficiency judgment

▪ Key issues for banks
  ○ True value of your collateral vs. the court’s opinion of value; burden of proof is on the secured creditor (bank)
  ○ Be aware of actions taken by other secured creditors, particularly if your bank has a secondary lien on the asset

▪ Cram Down
  ○ Often-threatened but little used maneuver in reorganizations when much time has elapsed and parties are not reaching agreement on a plan
  ○ So called because it cram an unpalatable plan (engineered by primarily the secured creditors) down the throats of creditors with the least amount of clout – those with secondary liens/claims and unsecured creditors
Other Tips

- In most business cases, you will need an attorney to guide you through the process
- At the first hint of bankruptcy, get attorney involved to:
  - Review your files for documentation errors
  - Conduct vigorous lien searches (mortgages and UCCs)

The 2005 Bankruptcy Law

- Address difficult areas of 1978 bankruptcy Reform Act
  - Process can be too long
    - United Airlines spent 38 months in Chapter 11
    - Average is supposedly 24 months
  - Administrative expenses consume 5-10% of debtor’s assets
  - Perception of being too easy to liquidate and leave numerous unsecured creditors receiving $0
  - Large firms were able to pay exorbitant salaries and other perks to induce management to stay through the process
- Rush to file under old law (deadline of Oct. 17, 2005) exceeded expectations, so backlog has slowed incidence of cases under new law, so it will take time to develop case laws as new guidance
- Means Testing — The new law has minimum income levels above which a person cannot file Chapter 7 and must reorganize
  - See Dept. of Justice website (www.doj.gov) for various forms (Form B22A and Form B22C) for determining allowable levels of monthly income and living expenses
  - Allowable local housing expenses are very low, and the difference between typical mortgages leave "income" that places most debtors above the Chapter 7 minimums
- Credit Counseling required for consumers prior to filing
More Duties Placed on Attorney to assure that all information provided by debtor is accurate and complete

Competing Plans – Hard deadline of 18 months for exclusive right of debtor to file reorganization plan

Commercial Leases – Another firm deadline of 210 days to assume or reject a commercial lease without landlord’s consent (was 60 days, but numerous extensions were frequently granted)

Shorter Repayment Period for Tax Claims of five years from date of filing, or no longer than repayment of any non-priority creditor that is paid upon confirmation

Priority Treatment of Trade Creditors (20-days window) and Employee Wages and Salaries (180-day window) plus increase in priority amount for each employee

More Practical Treatment of Preference Payments for smaller trade creditors, although probably more costly for the debtor

Employee Retention Payments Limited based on pay levels of other employees

Overall, Debtors will Need More Cash both to enter and to exit Chapter 11, administrative costs will be higher and priority claims likely higher

Is it possible to repeat the Past??????

Credit management check-up/challenge

- Due diligence
- Analysis must go beyond financial
- History more important than projection
- Yield cannot justify excessive risk
- Policy exceptions on LTV and terms
- Is there any “real” equity in the deal – CASH REALLY IS KING!
- Lender objectivity and independence
- Balanced incentive plan - the 3-legged stool.
Are We Smarter Today?

- Earnings Pressure
- Competition
- Trained lending staff
  - Adequate Loan Loss Reserve at all times
  - Solid, Understood, and Tested Methodologies
- No directed chargeoffs of other real estate, other assets, interest earned not collected and loan principal
- All classified assets identified internally and more severely than external classification
- All loan losses taken from internally classified “Doubtful”
- Independent loan review and audit function
- Adequate budget and strategic plan
- No violations of laws, regulations, directives and policies/procedures

Outlook and Avoiding the Past - Who will be Winners?

- Those with a culture and discipline to apply risk management tools
- Those who read warning signs early - individual and portfolio levels
- Those who cull the winners from the losers early – migration analysis
- Those who are proactive - have a sense of urgency
- Those who think like a “trader”
- Those who are honest in origination and review of credit - do not sell the deal to the approval authority
- Those who stick to their knitting
- Those who staff properly and arm them with tools necessary
LET US REMEMBER..............

“Those who Forget and Fail to Learn from the Past are condemned to Repeat It”

and

“It’s a Person’s Ignorance that gets Them Into Trouble and Their Arrogance that Keeps Them There”