

# Distressed borrowers should be aware of the trends in loan modifications

When the economy first began to decline, most commentators thought it would be a relatively short downturn, followed by a gradual return to normal market conditions. According to governmental reports, the recession officially ended in the second quarter of 2009. However, small-business owners and those in the real estate business would certainly disagree, as the impact of the recession on their businesses has not changed significantly with the end of the recession. With banks still holding to high credit standards and lenders still attempting to shed real estate loans from their books, borrowers undergoing the loan-renewal process or facing a looming maturity date on their loan continue to face an uphill battle. These borrowers that have been hit hardest by the recession must review and familiarize themselves with recent trends in loan workouts in order to protect themselves and their assets during the grueling process of negotiating a solution.

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While most borrowers attempt to take action well in advance to address these issues, and most loan officers are aware of the problems borrowers face, the lending policies and regulations governing their decision making do not always allow for a successful loan modification. In recent months, as regulatory pressures and requirements have changed, lenders have proposed solutions to loan modifications that include taking the collateral back through a deed in lieu of foreclosure or a friendly foreclosure, usually with the deficiency, if any, to be paid by the

borrower or guarantor to be negotiated in advance. In some cases, lenders may even be willing to forgive any deficiency entirely, based on the quality and marketability of the collateral, the financial condition of the borrower and guarantors and the desire to resolve the transaction by a specified deadline.

A similar alternative involves a note purchase by a third party or, in some extreme cases, by the borrower or guarantor themselves. In this scenario, a third party purchases the loan documents for an agreed-upon discounted price and then steps into the shoes of the lender. The third party and the borrower are then free to restructure the loan in a way that allows the borrower to continue with the project with more feasible terms reflecting its current financial condition.

While lenders have favored these options as a way to bring about a quicker resolution, borrowers must consider the tax consequences of any transaction and structure it accordingly. For example, without investigating the tax consequences and engaging in proper planning, a borrower could purchase its note at a discount, only to find that it faces a large tax bill because of the resulting cancellation of indebtedness income arising from the note purchase. Solving one problem accomplishes nothing if the borrower then faces a tax bill that it cannot pay on April 15.

When lenders are not willing to consider a loan workout or any of these options, a borrower may have no choice left but to consider a bankruptcy filing. Most borrowers looking to protect their assets file under Chapter 11 of the Bankruptcy Code because that allows them to continue their business operations subject to the oversight of the bankruptcy court, to remain in control of their bankruptcy case and to propose their own plan for dealing with their creditors. Borrowers filing Chapter 7 cases have their assets liquidated by a trustee and have their business operations cease on or shortly after the filing of the case. A filing under either

chapter immediately stops all foreclosure actions, litigation and collection activities as a result of the automatic stay, which goes into effect upon the filing of the case. The purpose of the automatic stay is to provide the borrower with time to prepare a plan to address the repayment of its creditors, either through continued business operations, sales of some or all of its assets or the surrender of property to the lender.

When borrowers are willing to surrender or sell a lender's collateral but face a lender whom they believe is undervaluing the assets or unwilling to provide a reasonable marketing time, a Chapter 11 provides two useful tools that can help a borrower receive a more fair price for its assets. First, in a bankruptcy case, a borrower can propose to sell some or all of its assets free and clear of all liens — even if the lender will not be paid in full — and then distribute the net proceeds to creditors. This can be done either as part of a Chapter 11 plan or by motion if an offer is received before a plan is approved by the bankruptcy court. The borrower's plan may propose a reasonable marketing period for the assets, during which time payments may or may not be made to the lender, depending on the terms approved by the bankruptcy court. The ability to sell assets free and clear of liens allows a borrower to potentially sell assets for a higher price than the borrower would get at a typical foreclosure fire sale while still being able to convey a good and marketable title to the purchaser because the free-and-clear order entered by the bankruptcy court eliminates the need to obtain a release of the lien from an unwilling lender.

A second tool making a comeback is the concept of surrendering property to a lender for a court-approved credit against the debt. These so called "dirt-for-debt" plans typically occur when a borrower and lender have widely different opinions as to the value of the collateral and the borrower wishes to avoid having a foreclosure sale determine the amount of the credit against the debt. Most courts have permitted a total surrender of all of the collateral or even a partial surrender of some of the collateral under these dirt-for-debt plans, although the standard for a partial surrender of the collateral is much higher than the standard for surrendering all of the collateral. These dirt-for-debt plans typically occur only when the collateral surrendered is of sufficient value to

satisfy the entire debt, after taking into account various discounts from the property's current fair market value to protect the lender for the costs associated with the liquidation of the assets and the amount of time it will take to realize the proceeds from the liquidation. These cases rely heavily on testimony by appraisers and other experts about the current fair market value of the property, the amount of marketing time needed and other discount rates to be applied.

In this era of depressed real estate prices, limited or no credit and cash-starved borrowers, dealing with a lender who seemingly has all of the leverage can seem like a no-win situation. Therefore, borrowers must familiarize themselves with all available alternatives — and the consequences of those alternatives — before any agreement is reached. While the ultimate goal is to minimize the risk of any deficiency, the protection of future appreciation or value in the assets should not be ignored for good projects simply to obtain a quick resolution. In these ever-changing times, proposals a lender would not consider a year ago may be an option today, and borrowers should actively explore all available options, including protecting their assets with a bankruptcy filing if necessary, as part of the overall solution.



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**Trawick H. Stubbs Jr. and Laurie B. Biggs** with Stubbs & Perdue PA focus on Chapter 11 reorganizations, workouts and debtor-creditor transactions. Stubbs is a board-certified specialist in business and consumer bankruptcy, a standing Chapter 13 trustee, and was recognized in *BUSINESS NORTH CAROLINA*'s Legal Elite for bankruptcy from 2002 to 2010. He received his law degree from Duke University. Biggs is a board-certified specialist in business bankruptcy and was recognized in *BUSINESS NORTH CAROLINA*'s Legal Elite for bankruptcy and the Top Lawyers Under 40 in 2007, as well as *BUSINESS NORTH CAROLINA*'s Young Guns in 2010. She received her law degree from the University of Kentucky.