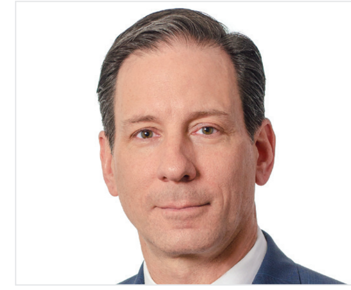
ASK THE EXPERT

# Dealing with default: workouts, restructuring, bankruptcy and litigation



Robert J. Malatak, Esq., CPA, a partner at the law firm of Windels Marx Lane & Mittendorf, LLP

At a time when virtually every sector of the economy is navigating unforeseen challenges brought on by the Covid-19 pandemic, commercial borrowers may find themselves unable to continue paying off debts under their current terms. To learn what borrower and lender options are in case of default, **Crain's Content Studio** turned to Robert J. Malatak, Esq., CPA, a partner at the law firm of Windels Marx Lane & Mittendorf, LLP, who has experience in bankruptcy, commercial loan restructuring and workouts, and enforcing judgments against recalcitrant debtors.

**CRAIN'S: How have the recent shocks to the economy affected commercial borrowers' ability to make debt payments?**

**ROBERT J. MALATAK, ESQ., CPA:** Although certain business sectors have been more impacted than others—for example, retail, hospitality and commercial real estate—given the complexity of the United States economy and interconnectedness of its business sectors, virtually no sector has been entirely unscathed by the economic impact of the Covid-19 pandemic. While certain borrowers were struggling economically prior to the pandemic's onset and then had their situation exacerbated by the pandemic, other borrowers' distress can be attributable solely to the pandemic. Either way, many borrowers presently find themselves in breach of certain financial covenants in their loan documents or unable to make their debt payments.

**The issue is not one of the lender's willingness to work out a distressed loan, but rather their ability to do so, which is still largely guided by pre-Covid-19 external and internal rules and regulations.**

**CRAIN'S: What's your advice for a commercial borrower that is currently facing a default or has defaulted?**

**MALATAK:** A borrower nearing default or already in default under the terms of a commercial loan should seek the advice of experienced counsel who can competently advise on not only the borrower's rights and obligations, but also those of the lender. Borrowers and lenders alike are best served when all parties are fully informed. Borrowers are also typically reluctant to notify their lenders of pre-default problems, and too often their lenders learn of problems through the borrowers' financial statements, or worse, public sources. This reluctance justifiably creates distrust on the lenders' part and can be an impediment—albeit not necessarily insurmountable—for a workout plan to succeed. If a lender does not trust the borrower's management and financial statements, it may appropriately believe that it has no choice but to enforce its rights and remedies under the loan documents, at law and in equity, which will be far less attractive than a workout.

**CRAIN'S: When should a commercial borrower in default consider a workout—negotiating with its lender to try to settle the debt with a reduced balance? Which lenders—and what kinds of loans—are particularly well-suited to that approach?**

**MALATAK:** A borrower whose liabilities exceed assets, or who lacks the cash flow to pay debts when they come due, is effectively insolvent. The borrower then has three choices: (1) ignore the problem and wait for the unavoidable lawsuits and/or possible involuntary bankruptcy, (2) attempt to negotiate a workout with the lender or (3) voluntarily file for bankruptcy. A responsible borrower will not ignore the issue but will first meet with trusted and competent advisers—including counsel and accountants—to develop a strategy and then meet with the lender in an attempt to outline a solution before the economic situation becomes overwhelming. The workout options can include, among others, a loan modification, a refinancing of the debt by a third-party lender, the borrower's transfer of the property to the lender by deed in lieu of foreclosure, or a sale of the secured property to a third party.

The foregoing approach is better suited when the borrower has only one lender. When multiple lenders are involved, the challenges for a workout grow significantly because they likely have competing interests, and all want access to available cash. Finally, loans that are secured by assets having equity above the amount of the borrower's present indebtedness or where the company and its owners can pledge additional collateral security, or personal guaranties, are more likely to be worked out.

**CRAIN'S: How does a commercial borrower looking to restructure decide between negotiating new terms with the current lender and refinancing with a new loan?**

**MALATAK:** Whether a borrower decides between a loan modification with the existing lender or a refinancing through a prospective lender will be determined by the strength of the borrower's relationship with the existing lender and the terms being offered by the existing and prospective lenders. The relationship between a lender and a borrower, like any other business relationship, can be a very amicable and trusted one. If that is the case, and the only negative development was an extraordinary event like Covid-19, the borrower may very well prefer to stay with the existing lender. However, whether it is economically feasible to do so will depend on the borrower's cash flow and the terms being offered by the existing lender versus the terms being offered by the prospective lender.

**CRAIN'S: What do commercial borrowers need to understand about their lenders' interests when negotiating with them? How does the current public-health and economic crisis affect a lender's willingness to work out a troubled loan?**

**MALATAK:** A borrower needs to understand that a lender must know whether the lender is fully secured by the assets pledged as collateral and personal guaranties, and whether the borrower's business is viable or not—and if not, can it be made viable and over what time horizon. As previously mentioned, however, if a borrower has loans with more than one lender, the lenders might have competing interests which should be discernable by understanding the terms of the various loan documents. As for lenders' present "willingness" to work out a distressed loan, lenders are not desensitized to the impact of Covid-19 and they much prefer having a performing loan in their portfolios than a nonperforming loan. The issue, however, is not one of the lenders' willingness to work out a distressed loan, but rather their ability to do so, which is still largely guided by pre-Covid-19 external and internal rules and regulations.

**CRAIN'S: When is bankruptcy, as opposed to a workout plan, the better option for a business facing default on a commercial loan?**

**MALATAK:** The issue of whether a company should file for bankruptcy and what kind, such as Chapter 7 or 11 (including Subchapter 5 under Chapter 11), requires a complicated factual and legal analysis that should be undertaken with the advice of competent and experienced advisers. As an aside, Subchapter 5 was created to help small businesses reorganize in a quicker and less costly manner and might well be a good option in today's environment. A company should consider as part of its analysis whether it is able to work out its distressed loan on terms that it honestly believes it can satisfy. If not, the company will likely soon find itself in default of the modified loan and without any additional options for a second workout or a third-party refinancing, particularly if the company's fortunes have continued to erode and many other creditors are knocking at the door.

**CRAIN'S: If you are the lender, what's the best way to enforce a judgment against a recalcitrant borrower and guarantor(s)?**

**MALATAK:** A lender that obtained a judgment has many legal rights and remedies to enforce it. However, in order for a lender to take full advantage of these rights and remedies, its counsel must be very familiar with them, as well as the procedural nuances surrounding them. Counsel who is knowledgeable in this area of law will press a lender's rights and remedies with precision and timeliness because failure to do so may result in: (1) certain lender's rights and remedies being waived or lost, (2) lender's judgment lien being subordinated to more aggressive competing creditors and/or (3) available assets being overlooked or fraudulently transferred or encumbered (which only invites further litigation). Finally, a lender with a judgment needs to be patient because if its rights and remedies are executed upon in a precise and timely manner, and if there exist assets against which its judgment can be wholly or partially satisfied, it should eventually be satisfied.