I. INTRODUCTION.

What is a workout? Just what it sounds like. Basically any arrangement in which the loan obligations of the borrower, lender or third parties are modified in a default situation or to prevent a default. A workout may result in a continuation of the loan (e.g., extension of maturity) or a termination of the loan (e.g., a payoff or a deed in lieu). Workouts may be within or outside of bankruptcy. A workout is obviously cheaper if done outside of bankruptcy, but bankruptcy provides powers (e.g., termination of contracts, stay of foreclosures, ability to obtain new financing) that can facilitate the workout.

One typically thinks of a workout in terms of a consensual arrangement, but the workout may occur within the context of nonconsensual actions, e.g., commencement of foreclosure or appointment of receiver.

The more players, the more difficult a workout becomes. For example, increasing the amount of the first mortgage loan prejudices the junior liens. Construction changes may require the consent of unfriendly subcontractors.

Examples here assume a real property secured loan.

II. KINDS OF WORKOUTS.

A. What is the Problem?

"Out of Balance" construction loan. The undisbursed loan funds are not sufficient to complete construction. The lender requires more non-loan funds. This could be caused by:

Construction delays
Unexpected price increases
Inadequate contingency funds
Problem work or contractors

Redesign. The project needs to be changed because it is poorly conceived or misses the market (e.g., live-work units).
Is it the developer or the architect/contractor?

Failure of Sales. Typical problem now for condos. Contracts are signed but no closings. The developer is also spending valuable time and money defending itself from cancellation requests and lawsuits.

Downturn in Economy. This includes properties becoming distressed because of significant increases in tenant vacancies.

B. What is the Business Plan?

The workout is basically the means to accomplish the business plan. The workout allows the business plan the time or money it needs to succeed. Without a viable business plan, the workout makes no sense. Like bankruptcy, the business plan may involve a liquidation of some kind, modification of loan terms or other restructuring.

C. Some Common Examples.

Modification of the loan: e.g., lower the note rate, increase the loan amount, extend the loan term.

Provide new funds: obtain additional project funds through new debt or equity.

Provide additional collateral or credit enhancements for the loan, including additional guaranties or modifications to limited guaranties (or even assignment of borrower claims/cause of actions against third parties in connection with project).

"Friendly" foreclosure or deed in lieu.

Sale of property: portions of property could be released from deed of trust and sold off.

Sale of note: Borrower finds a friendly new lender who buys the loan at par or below par.

Assumption of loan: Lender finds borrower who assumes the loan.

Appointment of receiver.

A concession from borrower's other creditors, e.g., contractors.

III. LENDER STRATEGIES/CONSIDERATIONS.

1. Is there communication with Borrower?

2. Relationship with Borrower.

3. Is there an exit strategy?
4. Need to control the cash.
5. What will the lender do with the asset?
6. Expense and time considerations of foreclosing and holding property.
7. Completion of construction.
8. Pursue guaranties: full recourse, completion and carveout.
10. Opportunity to fix any loan problems (e.g., perfection).
11. Priority of liens and security interests (e.g., first vs. third).
12. Regulatory and shareholder pressures.
13. Special purpose entity issue.
14. Transfer taxes (deed in lieu vs. foreclosure).

IV. BORROWER STRATEGIES/CONSIDERATIONS.

1. Prospects/costs of long term success of project.
2. Personal liability (guaranty issues).
   b. See FDIC Website: 
      See attached page for excerpts from this website.
4. Fixing loan issues (e.g., DCR, partial releases, guarantor liability, etc.).
5. Tax issues.

V. SELECTED ISSUES RE LOAN MODIFICATIONS.
A. **Retaining Priority.**

1. **General Rule.** Generally, priority of the lien will be lost to the extent that junior lienholders are prejudiced by the modification, unless the junior lienholders consent and subordinate to the modification. Examples of modifications likely to be found prejudicial to junior lienholders: interest rate increases, shortening of the maturity date, debt increases. Other modifications may not be deemed prejudicial: maturity date extensions, interest rate reduction, interest deferral, debt reduction. Bottom line: any change that makes an increased demand on borrower's cash flow, increases likelihood of default or encourages lack of financial responsibility could be interpreted as prejudicing intervening lien claimants.

   a. **Examples-Priority Retained.** *Resolution Trust Corp. v. BVS Dev. Inc.*, 42 F.3d 1206 (9th Cir. 1994) (lienholder's subordination not nullified by extension of term of senior loan without subordinate lienholder's consent because extension did not materially increase risk of borrower default); *Lennar N.E. Partners v. Buice*, 57 Cal. Rptr. 2d 435 (Ct. App. 1996) ("An extension of a senior debt that merely alters the date of payments generally does not adversely affect the junior lienholders . . . [W]hen the obligation is increased, by an increase in the principal amount or an increase in the interest rate, the junior lienholder's position is worsened"); *Sackadorf v. JLM Group Ltd. P'ship*, 462 S.E.2d 64 (Va. 1995) (modification agreement did not materially prejudice junior lender; the modification was advantageous to junior lender by improving borrower's cash flow and making default less likely); *Gulesarian v. Fields*, 218 S.E.2d 397 (Mass. 1966) (execution of extension agreement, without consent of second mortgage holder, changing terms of payment of first mortgage note so that monthly payments of principal coming due to first mortgage holder within period of 24 months following execution would be postponed to maturity date of mortgage, with no increase in interest rate or principal, would not affect or diminish priority of first mortgage holder's security interest as it existed at time of execution of second mortgage); *Friery v. Sutter Buttes Savings Bank*, 61 Cal.App.4th (Ct. App. 1998) (senior lender did not owe junior lender duty of not substantially impairing junior lender's security through modification of senior debt, which modification involved an assignment of the loan and shortening of the maturity date, where junior lender was a "garden variety" lienholder who had not subordinated to the senior, bore no special relationship to the senior lender and had no extraordinary facts in her favor which would warrant imposition of such a duty); *Strong v. Stoneham*, 310 N.E. 2d 607 (Mass. 1974) (the priorities of first mortgages were not affected by agreements to increase the interest rates payable under two of the three notes entered into by the borrower and lender).

   b. **Examples-Priority Affected.** *Shane v. Winter Hill Federal Sav. & Loan Ass'n*, 492 N.E. 2d 92 (Mass. 1986) (first mortgage provided senior lender with right to increase interest rate by not more than 1%; borrower and senior lender's agreement to raise interest rate by 1.25% prejudiced junior lender because, among other things, it increased borrower's monthly loan payment by $657 thereby straining borrower's ability to make payments and contributing to borrower's default under first mortgage; junior lender had no right to contest interest rate increase to the
extent anticipated in recorded first mortgage); *Gulesarian v. Fields*, 218 N.E. 2d 397 (Mass. 1966); *Gluskin v. Atl. Sav. & Loan Ass'n*, 108 Cal. Rptr. 318 (Ct. App. 1973) (senior lender's and borrower's loan modification that reduced the principal amount of the senior loan, increased the loan's interest rate by 3.76%, shortened the loan's maturity to 10 months and added a balloon payment at maturity prejudiced junior lender because it increased borrower's likelihood of defaulting under the senior loan); *Shultis v. Woodstock Land Dev. Assocs.*, 594 N.Y.S.2d 890 (App. Div. 1993) (senior lender's and borrower's loan modification that increased interest rate of loan by 5% was prejudicial to junior lender because it increased the total amount of indebtedness under first mortgage); *Citizens & Southern National Bank of South Carolina v. Smith*, 284 S.E.2d 770 (S.C. 1981) (junior lender, a purchase money lender, subordinated its mortgage to senior lender's mortgage pursuant to a subordination agreement; without junior lender's knowledge or consent, senior lender and borrower agreed to a maturity date extension of one year; court held that as a result, senior lender lost its priority vis-à-vis junior lender since the initial maturity date on senior loan was a material inducement to junior lender's agreement to subordinate junior mortgage to senior mortgage).

2. **Language in Deed of Trust or Subordination.** Does language in the original loan documents, including the deed of trust or a subordination agreement, reserving to the lender the right to modify the loan without the consent of the junior lienholder prevent a finding of prejudice to the junior lienholder?

"If the mortgagor and the mortgagee reserve the right in a mortgage to modify the mortgage or the obligation it secures, the mortgage as modified retains priority even if the modification is materially prejudicial to the holders of junior interest in the real estate . . . ." The Restatement (Third) Property: Mortgages, Section 7.3(c).

*See also, 100 Eighth Ave. Corp. v. Morgenstern*, 150 N.Y.S. 471 (1957) (court enforced a subordination agreement even though interest rate increase modification by borrower and first lender, who was in first position by virtue of the subordination agreement, went beyond what was agreed to in subordination agreement). Legal commentators caution that the foregoing is not the majority case-law position, and there appears to be little case-law authority on this issue. *Nature's Sunshine Products, Inc. v. Watson*, 174 P.3d 647 (Ut. App. Ct. 2007) (an advance that otherwise would be beyond the scope of the senior mortgage term limiting advances to $75,000, would not be permitted to prime a junior mortgage lien even if the senior mortgage contained broad terms permitting modification of the senior lien). Certainly, language in the first deed of trust or subordination agreement allowing the first lender to modify the loan is far better than having no such language. That said, depending on the type of modification involved, it is not advisable to rely on such language to prevent a finding of prejudice to a junior lienholder. Bottom line: make certain that there is language in original loan documents allowing lender to modify or extend loan at any time for any reason without notice to third parties.

3. **Purchase Money Mortgages.**
a. **General Rule.** Some commentators caution that courts tend to protect and favor subordinated purchase-money mortgages (e.g., construction lender is placed in prior position to seller/purchase money lender). Best practice is to obtain consent of purchase-money mortgage holder to any loan modification, and to add language in the subordination agreement whereby purchase-money mortgage holder consents to extensions, renewals, modifications, etc. of the first loan, and that its lien will remain subordinate to the first lender's lien following such extensions, renewals, modifications, etc. Bottom line: have a well-drafted and comprehensive subordination agreement with a junior purchase-money lender.

b. **Case Examples.** *Gluskin v. Atl. Sav. & Loan Ass'n*, 108 Cal. Rptr. 318 (Ct. App. 1973) (modification agreement shortened loan term, increased balloon payment, increased interest rate from 6 1/4% to 10% and stated that there were no other interests in the property; court referenced strong public policy reasons to protect subordinating sellers, and that "a lender and borrower may not bilaterally make a material modification in the loan to which the seller has subordinated, without the knowledge and consent of the seller to that modification"); *Citizens & Southern National Bank of South Carolina v. Smith*, 284 S.E.2d 770 (S.C. 1981) (where the second mortgagee (to whose mortgage the purchase-money first mortgagee had agreed to be subordinated) extended the time for payment for one year without the subordinated first mortgagee's knowledge and consent, the second mortgagee lost its priority because the first mortgagee had agreed to be subordinated on the assumption that the second mortgagee would be fully satisfied on the initial due date); *MCB Ltd. v. McGowan*, 359 S.E.2d 50 (N.C. App. 1987) (seller sold property to developer and took back purchase-money deed of trust, which provided lien would be subordinated to construction financing and permanent financing in such amount as purchaser might "reasonably request"; purchase-money deed of trust holder would not subordinate to permanent financing; court held subordination language was too vague to be held enforceable, since it failed to state maximum amount for subordination, contained no formula to determine maximum amount, and failed to describe the terms of the permanent mortgage that would be acceptable). See also, *Community Title v. Crow*, 728 S.W. 2d 652 (Mo.1987) (purchase-money borrower obtained another mortgage from bank to build a house; although purchase-money lender had agreed to subordinate its mortgage to another mortgage for such purpose, the bank mortgage did not mention the prior purchase-money mortgage; nonetheless, the court affirmed priority of bank mortgage over purchase-money mortgage since purchase-money lender had agreed to subordinate its mortgage and had communicated this agreement to bank); *Poyzer v. Amenia Seed and Grain Company*, 409 N.W. 2d 107 (ND 1987) (court held that oral agreement of mortgage lender, which did not record its mortgage, to subordinate its mortgage to a subsequent mortgage, which subsequent mortgage was recorded, was enforceable based on doctrine of part performance; subsequent mortgagee had performed title search showing no prior mortgage of record and had advanced $90,000 to borrower); *Southern Floridabanc Federal Savings v. Buscemi*, 529 So. 2d 303 (Fla. App. 4th Dist. 1988) (court held that subordination provision in purchase-money mortgage was effective despite junior mortgagee's failure to obtain a specific confirmation from the purchase-money lender; court stated that...
foreclosure is an equitable action and equity will not allow a purchase-money lender to evade its obligations).

c. **Effect of Prejudice/Remedy.** To what extent is the senior lienholder's priority impaired? Most likely just to the extent of the "unauthorized" modification. See e.g., *Shane v. Winter Hill Federal Sav. & Loan Ass'n*, 492 N.E. 2d 92 (Mass. 1986) (senior lender ordered to refund to borrower all payments made by borrower or junior lender to first lender in excess of the interest rate allowed under the first mortgage – 1%); *Shultis v. Woodstock Land Dev. Assocs.*, 594 N.Y.S.2d 890, 893 (App. Div. 1993) (junior mortgage granted priority over senior mortgage to the extent of the amount representing the increased interest due and owing to senior lender as a result of loan modification - approximately $7,200; court refused to grant junior mortgage total priority over senior mortgage, but noted in some circumstances prejudice could be so severe as to justify that remedy); but see *Citizens & Southern National Bank of South Carolina v. Smith*, 284 S.E.2d 770 (S.C. 1981) (court reversed priorities of junior and senior lender).

4. **Subordination Agreements.** As shown above, though courts tend to protect the rights of subordinated purchase-money mortgage lenders, subordinated purchase-money mortgages will not necessarily be protected from the enforcement of well-drafted and comprehensive subordination agreements; provided however, subordination agreements must be set forth with specificity and must not be waived by the parties' conduct or actions. See, e.g., *Life Savings and Loan Association of America v. Bryant*, 467 N.E. 2d 277 (Ill. 1984) (court held that failure of contract-for-deed vendor to satisfy conditions to which subordination provisions of contract were made subject to, restored purchaser's contract to its priority over subsequently executed mortgage by vendor because of mutual negation or waiver of subordination provision); *Jurado v. Simos*, 519 N.E. 2d 1018 (Ill. Ct. App. 1988) (subordination provision contained in purchase-money deed of trust contained provision that purchase-money lender would subdivide its position "in such amount as may be reasonably requested" by purchase-money borrower; court held that this requirement of future agreement in the material terms rendered the clause void for indefiniteness).

5. **Retaining Guarantor Liability.**

a. **General Rule.** Provided guarantor gives consent in the guaranty to future modifications of the loan, and waives right to notice and approval of any and all future loan modifications, guarantor will likely remain liable even if guarantor does execute/approve specific modification at the time it is entered into. That said, however, case law varies, and the best practice is to make certain that all guarantors execute the loan modification and reaffirm guarantor's obligations under the guaranty at the time of execution of the modification.

b. **Nevada Authority.** *Marion Properties, Ltd. By Loyal Crownover v. Goff*, 108 Nev. 1230 (1992) ("It is well-settled that guarantors and sureties are exonerated if the creditor alters the obligation of the principal without the consent of
the guarantor or surety”). *Southwest Securities v. AMFAC, Inc.*, 110 Nev. 1036 (1994) (cited the *Marion* case with approval but held that Southwest, the lessor-creditor, following the lessee's bankruptcy filing, did not alter the lease it had with lessee when it entered into operation and transition agreements with the bankruptcy trustee; as a result, Southwest could pursue lease guarantor).

c. **Other Authority.** General rule that a surety or guarantor for the performance of a contract or obligation is discharged if such contract or obligation is materially changed without his consent "does not apply where the suretyship or guaranty agreement itself permits the modification of the underlying obligation.” 23 Samuel Williston & Richard A. Lord, *A Treatise on the Law of Contracts*, § 61:31 at 105 (4th ed.2002). A guarantor may consent implicitly to post-guaranty modifications of the principal's underlying indebtedness by executing an explicit waiver of his right to notice or approval of such modifications in the language of the guaranty agreement. See e.g., *Restatement (Third) of Suretyship and Guaranty* § 48 (guarantor may validly waive rights and defenses in the guaranty contract); *John Deere Co. v. Babcock*, 89 Wis.2d 672, 676, 278 N.W.2d 885, 886 (1979) (court gave effect to guaranty agreement's clause waiving notice of successive extensions of credit); see generally, *Lakeshore Commercial Finance Corp. v. Drobac*, 319 N.W.2d 839 (1982) (court declined to impose guarantor's obligation on past terms that had been materially changed without guarantor's consent because the guaranty lacked “explicit language” extending guarantor's obligation to such changes) and *Gritz Harvestore, Inc. v. A.O. Smith Harvestore Products, Inc.*, 769 F.2d 1225 (7th Cir.1985) (applying Wisconsin law, court held that guarantor was not liable for debts occurred after dealership was terminated, noting that “nothing in the guaranty states explicitly or even suggests that the appellant was to be held liable” for such debts); see also *Restatement (First) of Security* § 129 comment e (1941) (“It should be observed that in certain cases especially those involving compensated sureties, an interpretation of the terms of the contract justifies the conclusion that the surety has consented to reasonable extensions or other modifications of the duty of the principal.”); *Beasley v. Wachovia Bank*, 627 S.E.2d 417 (Ga. App.2006) (guarantor expressly consented to modifications in terms of loan, in guaranty agreement agreeing that bank could “extend or modify the time, manner or terms of payment or performance and/or otherwise change or modify the credit terms,” such that language of guaranty agreement allowed bank to waive conditions precedent to making a loan, without affecting guarantor's obligation to guarantee the loan).

6. **Title Endorsement.** A lender's title insurance policy does not provide coverage for subsequent loan modifications. The policy insures the lender's lien as of the date of the policy and does not insure the terms of a later modification unless an endorsement is obtained to that effect. Best practice is to obtain an endorsement to the lender's policy of title insurance insuring the continued priority, validity and enforceability of the deed of trust lien following the modification. There are several alternatives.

a. **ALTA Endorsement Form 11.** Insures against loss or damage sustained by the insured by reason of (i) the invalidity or unenforceability of the
lien of the insured upon the title, at Date of Endorsement as a result of the modification, and (ii) lack of priority of the lien of the insured mortgage, at Date of Endorsement, over defects in, or liens or encumbrances on the title, except for those shown on the policy except for specific exception listed, if any.

b. **CLTA Endorsement Form 110.5.** Insures against loss or damage sustained by the insured by reason of (i) the failure of the modification to modify the insured mortgage or obligation secured thereby, and (ii) the priority of any lien or encumbrance over the lien of the insured mortgage as modified by the above mentioned agreement, except for those matters shown on Schedule B as prior to the insured mortgage and for specific exceptions listed, if any. CLTA Form 110.5 includes a creditors' rights exclusion; the ALTA Form 11 does not.

c. **First American Form 47.** Insures against loss or damage sustained by the insured by reason of a maturity extension of the obligation secured by the deed of trust "impairing the lien" of the insured deed of trust. Used when no deed of trust is recorded.

7. **Waiver of Automatic Stay - Enforceable?** Modifications will often contain covenants of borrower that if borrower files for bankruptcy, borrower agrees that lender is entitled to an immediate termination of the Section 362 automatic stay and/or that borrower will not oppose or contest a motion by lender to lift the automatic stay. A lender will often include such provisions to implement and effectuate the timely enforcement of state law remedies, e.g., receivership, foreclosure, assignment of rents. The Bankruptcy Code does not expressly prohibit pre-petition waivers of the automatic stay (Section 558 provides that waivers of defenses subsequent to the filing of the petition are not binding on the estate). Opponents of the pre-petition automatic stay waiver argue the provision is contrary to the rehabilitative goals of Chapter 11, usurp the authority of bankruptcy judges, etc.

Emerging case law generally holds that a pre-petition waiver of the automatic relief from stay may at least be considered as a circumstance in determining whether to grant relief from stay. See *In re Shady Grove Tech Center Associates Ltd. Partnership*, 227 B.R. 422 (D. Md. 1998) (Maryland bankruptcy court held that a pre-bankruptcy waiver was enforceable because it satisfied certain conditions, e.g., lender had granted substantial concessions, material consideration given by lender for the waiver); *In re Frye*, 320 B.R. 786 (Bankr. E.D. 2005) (stated that the case favored enforcement of the pre-petition waiver; but court would not make a final ruling until further evidence was submitted on various factors in connection with the waiver analysis); *In re Bryan Road, LLC*, 382 B.R 844 (Bankr. S.D. Fla. 2008) (debtor and lender entered into a court approved forbearance agreement during a foreclosure proceeding which contained a waiver from automatic stay; debtor filed for bankruptcy day before scheduled foreclosure sale; court allowed enforcement of waiver provision). Some courts, however, have refused for various reasons to enforce waivers of the automatic stay. See Judith Greenstone Miller and John C. Murray, *Waivers of Automatic Stay: Are they Enforceable (and Does the New Bankruptcy Act Make a Difference)*, 41 Real Prop. Prob. & Tr. J. 357,
370-72 (2006), which discusses the cases in this area, contains forms of waivers and suggests drafting strategies.

8. **Recording of Modification – Always Necessary?** Is it always necessary to record the loan modification? E.g., terms set forth in the deed of trust vs. maturity date extensions vs. interest rate reductions vs. release price changes. What about a memorandum of modification if the modification does not involve a modification to terms of the deed of trust?
V. What to do if You Experience Financial Difficulties

- If you are delinquent in making loan payments or can demonstrate financial hardship, you are encouraged to contact the FDIC to explore a loan workout program acceptable to you and the FDIC. Any proposal must be made in writing and will require current financial information and other supporting documentation needed by the FDIC to complete its analysis.
- Typically, such a program involves modifying the terms of your loan so that payment amounts are consistent with your ability to repay.
- If a loan modification is not feasible, the FDIC may consider a reasonable proposal to settle your debt for less than the amount owed. You should be aware that IRS regulations require the FDIC to report forgiveness of debt. You are advised to seek the counsel of your own tax professional.
- In situations where acceptable repayment terms or a mutually agreeable settlement cannot be reached to resolve a delinquent loan, the FDIC may pursue other legal options.

VI. Lines of Credit and Construction and Development Loans

- When the FDIC is appointed receiver, it immediately begins analyzing loans that require special attention, such as unfunded and partially funded lines of credit, and construction and development loans.
- The role of receiver generally precludes continuing the lending operations of a failed bank; however, the FDIC will consider advancing funds if it determines an advance is in the best interest of the receivership, such as to protect or enhance collateral, or to ensure maximum recovery to the receivership.
- In very limited circumstances, the FDIC will consider emergency funding needs required to ensure the short term viability of a borrower, to protect or enhance collateral value, or for public safety.

VII. Borrower Requests for Additional Funding

- If you submit a request for additional funding, the FDIC will conduct a thorough analysis to determine the best course of action for the receivership. The FDIC uses information contained in the failed bank’s loan files to the extent it is available and considered reliable.
- Because the files of failed banks are often incomplete or poorly documented, the FDIC may require additional information to perform its analysis and make a fact-based decision. Such information can include current financial statements and recent tax returns from borrowers and guarantors, and third party reports such as market studies and appraisals.

VIII. Potential Outcomes to Funding Requests

- Based on its analysis, the FDIC may:
  - Make all or a portion of the requested loan advance, as justified by the analysis. If funds are advanced for a construction project, the FDIC may require use of a third party escrow firm to control disbursements.
  - Undertake discussions with you to reach a mutually satisfactory agreement to restructure or modify the loan and funding commitment.
  - Exercise its statutory right as receiver to repudiate its funding obligations with respect to the loan if it determines that these obligations are burdensome to the receivership and that repudiation would promote the orderly administration of the receivership.
IX. What to Expect if the FDIC Sells Your Loan

- Holders of loans, including the FDIC, routinely sell performing and non-performing loans in the financial markets.
- If the FDIC sells your loan, either at or subsequent to the time your bank is closed, the FDIC and the new owner will send you a notice of the transaction, with payment mailing instructions.
- The sale does not affect the terms of your loan. The new owner of your loan:
  - Must comply with all state and federal laws with respect to the ownership and servicing of your loan, including the Fair Debt Collection Practices Act,
  - Is entitled to collect all principal, interest, and other amounts owed, and
  - Assumes the receiver's obligations and commitments.

X. Contacting the FDIC

- FDIC representatives are available to meet with loan customers normally within one business day after the bank failure and typically at or near the failed bank’s offices.
- Immediately after a bank failure, you can reach FDIC staff by calling the failed bank’s telephone number.
- The FDIC also establishes a temporary, specific 1-800 Customer Service line for every failed bank. This number is published in the FDIC’s press release for each failed bank. Press releases can be found for all bank failures at www.fdic.gov.