

**LOAN WORKOUTS:
PRACTICAL ALTERNATIVES TO THE COURTHOUSE**

37TH ANNUAL WILLIAM W. GIBSON
MORTGAGE LENDING INSTITUTE
THE UNIVERSITY OF TEXAS SCHOOL OF LAW

September 11-12, 2003 (Austin)
September 18-19, 2003 (Houston)

Donald G. Hawkes
Hawkes Law Firm P.L.L.C.
6060 North Central Expressway, Suite 560
Dallas, Texas 75206
dhawkes@hawkeslaw.com

(Houston presentation)

Kevin M. Kerr, P.C.
Attorney at Law
3100 Monticello, Suite 105
Dallas, Texas 75205
kevin@kerrlaw.com

(Austin presentation)

LOAN WORKOUTS: PRACTICAL ALTERNATIVES TO THE COURTHOUSE

Section 1: Introduction/ Overview.....	1
1.1. Scope of Article	1
1.2. Definition of a AWorkout.”.....	1
1.3. Overview.....	1
Section 2: The Calm Before the Storm, or How to Rethink How You Think.....	2
2.1. Evaluate Alternatives	2
2.2. Desperate People do Desperate Things.....	2
2.3. Exhibit A.....	2
2.4. Understand the Grief Cycle.....	2
2.5. Don’t Make Matters Worse.....	3
2.6. Think Outside the Box.....	3
2.7. Understand the Rules of Bankruptcy	3
2.8. Put it in Writing.....	4
2.9. Equitable Subordination/ Excess Control	4
2.10. Environmental Concerns.....	4
2.11. Analyzing Foreclosure	4
2.12. Close the Deal	5
2.13. Taxes	5
2.14. Securities Disclosures	5
2.15. Negotiation Tips.....	5
2.16. Curb the Hatred.....	6
2.17. Receivership.....	6
2.18. Leasehold Properties	6
2.19. Remedies.....	6
2.20. Legal Ethics.....	6
2.21. <i>Late Payments.</i>	7
2.22. <i>Prepare for Meetings.</i>	7
Section 3: Legal Issues That Affect Workouts.....	7
3.1. Guarantor	7
3.2. Good Faith.....	8
3.3. Statute of Frauds	8
3.4. Statute of Limitation	9
3.5. Title Insurance.....	10
3.6. Fraud in Real Estate Transactions.....	11
3.7. Consideration	12
3.8. Usury.....	12
3.9. Deed in Lieu of Foreclosure.....	12
3.10. Co-Guarantor Liability.....	13

3.11.	Sarbanes-Oxley	13
3.12.	Anti-Deficiency Rules of Foreclosure	14
3.13.	Farah.....	14
3.14.	Acceleration/ Waiver by Prior Actions	14
3.15.	12 U.S.C. ' 1001(a).....	14
3.16.	Lien Renewals.....	15
3.17.	Appraisals.....	15
3.18.	Power of Attorney.....	15
3.19.	Define Authority of Parties	15
Section 4: Preparation for a Workout.....		16
4.1.	Document Review.....	16
4.2.	Certificates	18
4.3.	Junior Lienholders.....	18
<i>Section 5: Drafting the Workout Agreement</i>		18
5.1.	Conditional Releases.....	18
5.2.	Cross-Collateralization.....	18
5.3.	Standstill Agreements	18
5.4.	Releases.....	19
5.5.	Drafting the Workout Documents.....	19
Section 6: Post Workout Considerations.....		21
6.1.	Communicate the Deal.....	21
6.2.	Impress on the Client to Keep Good Records Post-Workout	21
6.3.	Timing Before Foreclosure Day.....	21
Section 7: Summary		21

Exhibit A: *Negotiation Agreement Form*

Exhibit B: *Standstill Agreement Form*

Exhibit C: *Loan Review Checklist*

Exhibit D: *Loan Workouts - Bankruptcy issues*

Exhibit E: *Ethical Considerations*

LOAN WORKOUTS: PRACTICAL ALTERNATIVES TO THE COURTHOUSE

Section 1: Introduction/ Overview.

1.1. Scope of Article. We spend hours [and earn fees] drafting and negotiating loan documents for our clients. Most of the time, the parties never call back and never have any problems. Occasionally, as the economy turns down, businesses fail and loans go into default. A lender has certain legal rights under the loan documents and the law. But what happens when the legal rights available to the lender aren't what the client wants?

1.2. Definition of a "Workout." For the purposes of this presentation, we need to define a "workout." If the lender elects to pursue its legal remedies or the borrower simply walks away, there cannot be a workout. But if each side is willing to compromise to find an acceptable business alternative to the mutual advantage of each, you have a workout.

Another view of a workout is a situation where the lender accepts less than it is entitled to and the borrower pays more than it should, i.e., neither side is happy. A workout affords the lender an opportunity to return the loan to a performing status, to gain additional information about the borrower and the collateral, to possibly correct previous errors in the loan documentation and to potentially obtain additional collateral. It allows the borrower to maintain control of its asset and potentially avoid further damage to its credit.

While each workout is different, two concepts are worth remembering at the outset B (i) the earlier the borrower's financial distress is addressed and (ii) the more time is initially spent identifying and understanding the cause of the borrower's financial distress B the more likely the workout will be successful.

1.3. Overview. What follows in this article is an overview of issues that we've seen in workouts. We've tried to organize them in something of a logical and chronological order, but the very nature of a workout transaction defies logic in every instance.

Being more of an issue spotting and overview paper, we have not covered some of the topics in the detail that they deserve. We caution you to seek out other sources, if these issues arise in your transaction.

We have divided the topics into four somewhat arbitrary categories:

Section 2: The Calm Before the Storm, or How to Rethink How You Think.

Section 3: Legal Issues That Affect Workouts.

Section 4: Preparation for a Workout

Section 5: Drafting the Workout Agreement

Section 2: The Calm Before the Storm, or How to Rethink How You Think.

2.1. Evaluate Alternatives. A lawyer's usual starting point is to evaluate the legal rights available to the lender. But in a down economy, foreclosing on an under-leased building and the privilege of spending money on legal fees chasing someone whose business has just failed, may not produce the best result. In other words, do your legal rights really get you what you want?

2.2. Desperate People do Desperate Things. As lawyers, loan documents represent pieces of paper in file cabinets. But to the customers, these are not merely pieces of paper. This loan is his life. This deal is her ability to feed and shelter her family. Always keep in mind that when you consider taking adverse action under loan documents, you are cornering the equivalent of a wild animal that will attack any way it can. Remember all of the lender liability counterclaims that were created in response to the bank failures?

2.3. Exhibit A. As tensions heat up and the fur is flying, make sure you [and your clients] carefully draft each letter. You should assume that every letter you write will be the "Exhibit A" to the borrower's petition or counterclaim. Strive for simplicity, clarity and respectfulness. This approach will at times require "turning the other cheek." The goal is to attack the problem and not the individual. Make sure your client understands this also. I had a lender client get baited into a shouting match where he threatened to have the police come out and arrest the borrower.

2.4. Understand the Grief Cycle. Most people have heard of the "psychological grief cycle" when it comes to a personal loss, such as the death of a child. But it also applies to a business tragedy situation.

a. **Denial.** The first reaction to a loss is denial. Think back on some of the meetings with borrowers. When the banker said the situation was hopeless and the bank would have to foreclose, the response was "there's not a problem. I can turn this thing around. I have a new plan underway right now."

b. **Anger/ Blame.** After the denial phase wears off, anger quickly sets in. Most borrowers reacted to the business failure with an attack on the bank. "There wouldn't have been a problem if . . ."

c. **Acceptance.** At some point, acceptance kicks in. In a loan situation where a business had failed, the owner was working overtime to save it. He fired his accountant to save money. The bank insisted on good numbers/ forecasts. The owner finally agreed and

rehired his accountant. After the numbers came in, he realized that he was actually losing money on every sale. He accepted the situation and agreed to allow the foreclosure.

d. **Resolution.** It is only when the parties get to the resolution stage that you can negotiate a workout. After understanding this process in the workout scenario, we realized that you can't "force" a settlement when the borrower was in the denial stage.

Not every person goes through the process the same way. Some have longer cycles and some never progress all the way through it. One thing you can count on is that the more the person is personally involved, the deeper the grief cycle will be evident.

2.5. Don't Make Matters Worse. Consider yourself to be in a litigation mode during the workout process. While it is important to meet with the borrower to consider alternatives, you need to avoid claims that can arise during this time frame. Consider using a negotiation agreement to conduct meetings.

We don't recommend a long involved form. A short simple letter agreement that confirms that the parties will discuss options but that the lender is not waiving any rights, unless an agreement is signed by all parties. Be sure to include any guarantors to the agreement. A negotiation letter can also be invaluable if the negotiations fail and subsequent litigation occurs. In the Bluebonnet case, the borrower signed a "settlement negotiation letter" as part of the negotiations. The borrower was a self employed businessman who had closed a number of real estate transactions. The court found that the businessman's experience (combined with his having signed the letter) made the borrower's subsequent claim that he had an agreement to refinance was not reasonable. Bluebonnet Sav. v. Grayridge Apt. Homes, 907 S.W.2d 904 (Tex. App. B Houston [1st. Dist.] 1995, writ den'd.). A sample agreement is attached as Exhibit "A".

We do not like the forms used by some attorneys in the foreclosure days that required the borrower to waive all claims and defenses as a condition to meeting. You may as well not meet if that is your condition. Also, we were concerned about the jury's reaction to such a letter just for the privilege of talking.

2.6. Think Outside the Box. Remember, you've decided that the legal rights aren't necessarily what the lender needs [in light of all considerations]. Be sure to ask, "what do the parties really want?" Is there something that the lender can get only by agreement?

2.7. Understand the Rules of Bankruptcy. It is beyond the scope of this presentation to fully explore the rules of bankruptcy, because the rules of bankruptcy are beyond the scope of the authors' abilities. If bankruptcy should occur, get good counsel. We've included a n Addendum to this Article prepared by Diane Reed on bankruptcy related issues to a workout.

2.8. Put it in Writing. Early on the parties may agree informally on little things. With the assumption that all workouts will end up in court, be sure to document all agreements. Make sure that correspondence with the borrower is not interpreted as loan modification documents when the correspondence only refers to the loan being evaluated for a possible modification or workout. In Stiggers, the borrower received a letter from Fleet in which it was agreed that the lender would grant the borrower a “special forbearance” to her. The borrower subsequently requested a workout option and sent in her financial information. She was told over the phone that she would get a second six month forbearance, but never got written confirmation. She later got a letter from Fleet denying another review of her account. The borrower did not prevail in the case because the correspondence from Fleet provided that Fleet “would reevaluate your file for a loan modification Y., once [your income] is established”. Stiggers v. Fleet Mortgage Corp. 2001 W 984795 (Tex. App. B San Antonio).

2.9. Equitable Subordination/ Excess Control. Equitable subordination is a claim that a senior lienholder took advantage of its position and required the borrower to act in a favorable way to pay back the loan to the detriment of others. Generally, a senior lienholder maintains a higher lien position to a later (junior) lienholder unless that senior lienholder has acted to cause its lien to fall in priority. Be careful in situations where the lender knows that current bills for services [such as landscaping, payroll taxes, salaries] are not going to be paid while the lender is capturing all of the rents in a lock box to go to the loan.

2.10. Environmental Concerns. Environmental issues are a particular concern for lenders. You should get both representations regarding the use and presence of contamination and conduct an environmental survey of the property. For instance, the borrower may have leased to a tenant in his shopping center (that serves as collateral) and the tenant (before its bankruptcy) may have been a dry cleaners. A cursory investigation by the landlord revealed that the tenant used the area behind its store to dump all of the used cleaning chemicals. The landlord, because of his poor financial condition, may not be very forthcoming about the collateral’s condition unless he is required to give the representation and/or provide an updated environmental report as a condition of the workout. The requirement for representations about the collateral’s condition provides the lender with additional information to determine whether it wants to make the loan workout on the original terms discussed. It may be necessary to restructure the original loan workout to add additional funds to remediate the environmental condition.

2.11. Analyzing Foreclosure. Early in the workout process, be sure to ask if your loan officer knows what it means to actually “own” real property. When the customer is offering a cash flow mortgage, you need to be able to compare that to the lender’s performance as a property owner. Everyone that lived through the last down turn will remember stories of buildings without janitorial services, etc. and tenants moving out due to

the owner's negligence in management. It is very easy to criticize a borrower's performance, but consider carefully if you can do better.

Also, be sure to consider the affect on leases on the property. With an economic down turn, the tenants are also probably trapped in high rent leases. Most loans on small centers do not have SNDA's in place for all tenants. Will your foreclosure give tenants a free walk from the Center?

2.12. Close the Deal. Attempt to resolve all issues while the parties are "at the table." Workout negotiations require both patience and the ability to get all of the parties to the negotiation to focus until all of the critical issues are resolved. The subsequent lack of agreement on one issue (which wasn't anticipated at the original negotiations) can disrupt an otherwise settled loan workout. An unpublished Dallas Court of Appeals opinion referenced a mediated dispute over a ground lease in North Dallas. Thornton v. Ventura [1996 WL 132237]. The landlord and tenant reached an agreement during the mediation and filled out and signed a pre-printed settlement agreement form provided by the mediator. The agreement provided that for the transfer of the ground lease in return for the payment of \$1.9 million. There were also provisions relating to how the obligations to the lender would be handled. Following the agreement, the parties exchanged drafts of the documents to be signed to perform the tenants of the settlement agreement. One of the documents provided for a note assumption and contained an indemnity. The disagreement over the indemnity resulted in the parties going back to court.

2.13. Taxes. While a detailed analysis of the tax consequences of a loan workout is beyond the scope of this paper, practitioners should keep in mind the potential federal income tax consequences of any workout. For example, if the workout provides that an existing borrower's indebtedness be forgiven, the borrower might be impacted by the forgiveness of debt / cancellation of debt income rules. Another tax consequence involves adding partners to a partnership as a credit enhancement for a loan. This concept is especially true for borrowers, be sure their tax advisor looks over the deal in advance of signing.

2.14. Securities Disclosures. In today's heightened awareness of disclosures under the securities laws, be aware that a publicly traded company (especially as a borrower) may be obligated to disclose a loan restructuring or workout in filings with the SEC and in disclosures to its shareholders.

2.15. Negotiation Tips. Workout negotiations can be some of the most extended and trying negotiations a transactional lawyer encounters. Usually, loan documents are negotiated in a fairly friendly and neutral manner, after all the borrower wants to get the money. However, in a workout, the money is already out the door and the lender has at least some doubts about exercising its legal remedies.

In small loan workouts, there is often just the individual borrower and individual loan officer as the key negotiators (or their respective attorneys). These parties can speak directly

and (while not always agreeing) don't usually have to worry about concepts or positions being filtered or "spun". When the workout has more parties and interests involved, it becomes critical to get a spokesman appointed especially if the borrower is a partnership or there are multiple creditors. Additionally, there will be third parties, who because of an economic interest or wanting to "facilitate" the deal will seek involvement. Accountants or consultants, sometimes known as "workout professionals," often fall into this category especially if the loan workout is part of an overall business restructuring. These individuals can be a double-edged sword. They may know about the borrower or loan specific issues which the corporate lender will not have knowledge. At the same time, they may be too familiar with the borrower and make statements to the opposing side which are contrary to the main negotiating positions. If the lender is a small community bank, it may not have an established workout department and also utilizes financial consultant. As the attorney, strive to keep control of the main negotiating position and minimize views that are at variance with the main negotiating position.

2.16. *Curb the Hatred.* In the 80's, banks learned to transfer bad loans to a new officer. The old officer [that made the loan and suffered the wrath of loan committee] often wanted a pound of flesh. Make sure there isn't some animosity between the client representative and borrower that could prevent a reasonable settlement from coming out.

2.17. *Receivership.* We have found that seeking a receiver to operate the property can be a very time consuming and expensive alternative to foreclosure. However, there are circumstances when a receivership is the best alternative. If the property is somewhat undesirable and possibly contaminated, the bank can get control of the property and keep a distance from the liabilities. For example, a lender chose a receiver for a low income apartment complex in the Houston area, because of the high crime rate in the area and very poor condition of the buildings. Initially, the borrower fought the receivership petition, but quickly settled on a receivership order that allowed it some control over sales efforts. Also, the lender was willing to advance funds for security and maintenance under a receiver's supervision.

2.18. *Leasehold Properties.* If the collateral is located in leased space, be sure to look for any landlord estoppel agreements in the file and check with the landlord. Your client [or its predecessor] may have a contractual obligation to give notices to the landlord.

2.19. *Remedies.* Be sure to review the "standard" loan documents and confirm your legal remedies [obligations]. Just because it is on the bank's "standard" form, your remedies may have been modified, either in the document or by an addendum.

2.20 *Legal Ethics.* Workouts provide a mine field of ethics problems. Be very careful, as borrower's counsel, that you clarify who is your "client" and be sure to advise other related parties that they need independent counsel. Also, there are situations where one party is paying fees but the client is another entity.

Finally, as an example, there was an interesting memo from a bank law department to all firms representing the bank. It reminded all attorneys that if an officer was not following the prudent advice of counsel, then the attorney must contact the law department. I assumed that some officer had done something stupid and the attorney said, "but that's not what I advised him/her to do." We have attached an ethics primer to this article.

For a very good discussion of the topic including extensive forms, see Barbra J. LaBarron's recent article, "Ethical Considerations and Malpractice Prevention in Real in a Real Estate Practice," 2002 Advanced Real Estate Short Course [University of Houston].

2.21 Late Payments. As a practice tip, consider other lender actions which may occur in the normal course of a borrower in the early stages of financial distress. For example, if a borrower falls behind in its payments and then makes a late or partial payment, what is the lender's response? Does the lender accept the partial or late payment without any other action? Does it accept the payment, but also sends a letter stating that it is not waiving its rights and explaining how the payment is applied? Understanding how the lender's practices address such matters can impact the subsequent nature of the workout negotiations. Additionally, question the lending officer about any actions which he or she may have taken concerning the borrower's collateral which may lead to claims of lender liability or control.

2.22 Prepare for Meetings. If you are representing the distressed borrower, emphasize that meeting with the lender should not be used as a means just to "buy time" in the belief that the borrower's financial issues will vanish in the interim. The borrower should consider preparing a presentation (often in concert with the company's accountant) or using a loan consultant (who are often retired bankers) as a way to demonstrate how the borrower can resolve its financial issues.

Section 3: Legal Issues That Affect Workouts.

3.1. Guarantor. Guarantors have long been called a "favorite of the law" and Texas courts have been willing to protect them and release them. See, McKnight v. Virginia Mirror Co., 463 S.W.2d 428 (Tex. 1971). Without citing a million cases, here are the general rules:

a. Absent an agreement in the guaranty, a material alteration will discharge a guarantor. What is a material alteration? If you have to ask, only a Court can answer it and you don't want to go there. [For a discussion of the three elements necessary to be shown to establish a "material alteration", see the case of Frost Nat'l. Bank v. Burge, 29 S.W.3d 580 (Tex. App. B Houston [14th Dist.] 2000, no writ).

b. Most guaranty agreements have very broad waiver language that will effectively bind a guarantor to the modification. For example, the following language has been held to keep a guarantor on the hook: "this guaranty is a continuing one and shall continue to apply without regard

to the form or amount of the indebtedness or obligation hereby guaranteed which [Lender] may create, renew, extend or alter ... without notice [guarantor].” Hernandez v. Bexar County National Bank of San Antonio, 710 S.W.2d 684 (Tex. Civ. App.- Corpus Christi 1986), writ ref’d n.r.e., per curiam, 716 S.W.2d 938 (Tex. 1986). As a practice tip, read the guaranty and confirm that it is a “continuing guaranty”. See Mann v. NCNB Tex. Nat’l. Bank 854 S.W.2d 664 (Tex. App. B Dallas 1993, no writ) and Chambers v. NCNB Tex. Nat’l Bank, 841 S.W.2d 132 (Tex. App. B Houston [14th Dist.] 1992, no writ). See also, Nelms v. Bird 1998 WL 175683 (Tex. App. B Hous. (14th Dist.)1998, unpublished opinion).

c. To avoid the risk that a guarantor will claim discharge, make sure the guarantor signs the renewal documents, regardless of the consent language. Keep in mind that Texas courts interpret guarantees according to the rule of *strictissimi juris* (“of the strictest right or law”) so the conditions of a guaranty are strictly construed. Vastine v. Bank of Dallas, 808 S.W.2d 463 (Tex. 1991, per curiam).

d. Speaking of discharge, old Texas case law has held that modifications to a loan documents without a responsible party’s consent, will discharge that party. Maier v. Thorman, 234 S.W. 239 (Tex. Civ. App.- San Antonio 1921, no writ).

3.2. Good Faith. Is there an obligation of good faith and fair dealing in workout negotiations? It appears that there is not. Section 1.203 of the Texas Business and Commerce Code states the general rule that “every contract or duty within this title imposes an obligation of good faith in its performance or enforcement”. Tex. Bus. & Comm. Code Ann. ’ 1.203 (Vernon 1994, Supp. 2002). Neither Section 205 of the Restatement of Contracts nor UCC Section 1.203 apply to good faith in the formation of a contract. In Commercial National Bank of Beeville v. Batchelor, 980 S.W. 2d 750 (Tex. App. -- Corpus Christi 1998, no writ), the borrower asserted that the bank’s failure to renew, extend and lower the payments under the note somehow violated its obligation to enforce the notes in good faith. The court stated that the bank’s previous acts of lenience with the borrower do not impose any obligation to continue such extra contractual lenience in the future based on the U.C.C.’s good faith provision. The court found that “what some might consider to be cold heartedness by the bank in not renewing or restructuring debt is not the equivalent of the absence of good faith. . . . A jury may not restructure or recast promissory notes or other contracts to satisfy their sense of justice contrary to the written agreement of the parties”.

Borrowers have also tried to argue that the good faith provisions of the UCC apply because the deed of trust referenced that it was also to be construed as a security agreement. The Court in Vogel held that because the deed of trust placed a lien on real property it was not governed by the UCC. The Court further noted that the deed of trust recited it was to be construed as a security agreement with respect to goods that are or are to become fixtures. Vogel v. Travelers Indemnity Co., 966 S.W.2d 748, 753 (Tex. App. B San Antonio 1998, no writ).

3.3. Statute of Frauds. The Statute of Frauds provides that if the terms of an agreement cannot be performed within a year from the date of the agreement, then that agreement must be in writing and signed by the party against whom it is sought to be enforced. The requirement of written agreements in Texas has several applications to workouts.

a. Guarantors. A promise to "answer for the debt, default, or miscarriage of another person" must be in writing. Tex. Bus. & Com. Code Ann. ' 26.01(b).

b. Filing Requirements. In order to put third parties on notice of a lien or interest in real property, the instrument must be in writing and either acknowledged, sworn to, or otherwise proved and recorded in the real property records. Tex. Prop. Code Ann. ' ' 13.001 and 13.002.

c. Deeds of Trust. Generally, a properly recorded deed of trust provides notice to third parties of the lien for four years after the original maturity of the debt secured. The limitations periods is suspended if a recorded extension agreement stating the new maturity is recorded during the four year period. Tex. Civ. Prac. & Rem. Code Ann. ' ' 16.035, 16.036 and 16.037. Be careful if the four year limitations period has run before the extension is recorded. There are some unresolved issues in the law if there are intervening claimants during this critical time period. As discussed in Thompson, "Modification, Extension and Renewal of Loan Agreements (Advanced Real Estate Law Course 1990), The law prior to the current law provided that a late filing of an extension would be effective against existing lienholders that were created before the lapse. The codification process seems to imply, according to Mr. Thompson, that an intervening inferior lien would be elevated by the lapse.

d. Loan Agreements. As result of the banking problems in the 1980's, the legislature passed ' 26.02(b) of the Texas Business and Commerce Code. Tex. Bus. & Com. Code Ann. ' 26.02(b) (Vernon 2002). Many claims were asserted against lending institutions based on a loan officer's verbal promises. Under this statute, for certain institutions, any loan over \$50,000 must be in writing to be enforceable if the loan documents contain the statutory warning and the lender posts a notice of the limitation as prescribed by the Texas Finance Commission. This is that law that requires the now famous disclosure that "there are no unwritten oral agreements." Presumably written verbal agreements are enforceable. There is a caveat in the statute that if the notice is not included, Section 26.02 will not apply to the transaction. More importantly, failure to comply with the statute allows the admission of parol evidence. Maginn v. Norwest Mort., Inc. 919 S.W.2d 164 (Tex. App. -- Austin 1996, reh'g denied).

The statute has not stopped borrowers from asserting that a lender breached an alleged oral contract to extend or delay payments under a note. A recent case involved a borrower asserting promissory estoppel as a defense to the statute of frauds. The defense failed, in part, because the promise element of promissory estoppel was a conditioned promise. The lending officer's oral offer to renew and extend the debt was conditioned on the borrower getting the Farmer's Home Administration approval. The evidence showed that the borrower never completed the paperwork for submission to the FmHA. Ford v. City State Bank of Palacios 44 S.W. 3d 121 (Tex. App. -- Corpus Christi 2001, no writ).

3.4. Statute of Limitation. We looked at the need to keep a deed of trust "current" of record by filing a notice of the extension of the maturity date. But what happens to a lien when an action on the debt becomes barred by limitations? A suit to recover on a note must be filed within four years of the maturity date. Tex. Civ. Prac. Rem. Code Ann. ' 16.035. There are other rights afforded certain institutions under federal statutes that can extend this deadline, if applicable. Once the debt expires, the lien securing the obligation also expires. See, Beeler v. Harbour, 116 S.W.2d

931 (Tex. Civ. App.-- Fort Worth 1938, no writ). If the debt has become barred by limitations, make sure that the modification agreement meets the requirements of Texas case law to restore the obligation: a clear acknowledgment that the claim is owing and a willingness to pay the debt or that the debt exists. See, House of Falcon, Inc. v. Gonzales, 583 S.W.2d 902 (Tex. Civ. App.-- Corpus Christi 1979, no writ).

3.5. *Title Insurance.*

a. **Modification Endorsement.** Procedural Rule P-9(b)(3), promulgated by the Texas Department of Insurance, is the applicable rule for modifications to deeds of trust covered by a mortgagee title insurance policy. The premium for the endorsement is \$100, if issued within one year and an additional \$10 for each year thereafter [Rate Rule R-11]. The coverage is actually very minimal, merely stating that the policy coverage has not been reduced or terminated by the modification agreement. It is not a down date of coverage, as some believe. If your client wants new insurance for the intervening period, you will have to request a new policy.

Because of a perceived abuse of modification endorsements by the Texas Department of Insurance, several prohibitions to the issuance of a modification endorsement have been added to P-9(b)(3). An insurer may not issue a modification endorsement if: (1) the agreement grants a new lien; (2) there is a new promissory note; (3) the lien secures additional indebtedness, other than interest on the original debt and advance described in the original deed of trust [i.e., paying taxes]; and (4) additional land is added to the lien. Be sure to consider these restrictions early in your planning. Of course, it does not necessarily mean that any of these restrictions will void or alter the coverage of a policy.

b. **Assignment Endorsement.** Procedural Rule P-9(b)(2) allows the insurer to issue an endorsement to confirm the new insured after an assignment of the lien, except for one-to-four family loans.

c. **Refinance Credit.** If you are making extensive changes as part of the workout and you run afoul of the Modification Endorsement restrictions, then you are probably left with a refinance of the original debt, which will require that you buy a new policy. Under Rate Rule R-8, you can get a credit of 40% of the premium on the outstanding principal balance [not the original balance or the new balance]. The credit drops by 5% if the renewal is more than two years after the policy date and continues to drop 5% each year.

d. **Second Lien.** Assume that you have a good insured first lien and you can modify it and get an endorsement, but you need to do more [i.e., advance more money have it secure other debt, etc.]. Consider filing a second lien instead of rolling everything into the first. It is possible that the premium on the new second lien amount is less than the refinance premium on a renewal loan. It is also possible that a lender will make a business decision to go uninsured on the additional advance.

e. Policy Coverage.

"Title policies are nothing more than receipts for the premium paid" B
Disgruntled Policyholder,
after reading the exclusions.

Of course, the same can be said for a well written legal opinion. Take a moment to read the "Exclusions" section of the policy. Many times a problem comes up with a property and it is not covered by the "Exceptions" section and therefore the insured thinks it is covered.

For the purposes of a workout, pay attention to Exclusion 3(b). This exclusion applies to information that the lender knows, but is not disclosed in writing to the insurer. If you have reason to believe that a problem exists, be sure to get a written acceptance- from the insurer, not just the closer- as part of the transaction.

Also, notice the very broad exclusion under number 8 for all bankruptcy, creditor's rights, fraudulent conveyance, equitable subordination, and preferences. These are the very issues that will arise in a workout and must be disclosed to the lender client as a risk of the workout.

f. Interim Construction Binder. Sometimes your file will have an Interim Construction Binder. If you're not familiar with those, see the Texas Title Insurance Basic Manual or call the issuer. The purpose of a Binder is to allow the construction lender to have coverage for a minimal fee during construction but not require a premium charge when the permanent loan comes on line. However, Binders have a one year term and can be renewed for a limited time. If your file has a Binder, make sure to keep it renewed and get the policy issued, if necessary. Once the Binder expires, the insurer has the right to add any intervening matters that affect the property. Also, try to confirm if the Binder was properly issued for the file. Sometimes the lender agreed to accept a Binder, even though the project did not meet the requirements for a Binder.

g. The Commitment. Commitments are only to be issued when the Company has a bona fide order for a policy, Procedural Rule P-18A. A Commitment is not to be used as a substitute for a policy of title insurance, P-18E. Do not request a Commitment on properties as a fishing expedition. You may have to explain to the Texas Department of Insurance why you placed the order and later cancelled it. If you need abstract searches, place the order as an abstract order and pay for the service.

h. Limited Pre-Foreclosure Policy and Endorsement. If you are considering foreclosure, look at Procedural Rule P-43 on the Limited Pre-Foreclosure Policy.

3.6. Fraud in Real Estate Transactions. As part of the file review, both as lender's counsel and borrower's counsel, consider '27.01 of the Texas Business and Commerce Code. Generally, a person is liable for actual and possibly punitive damages if he makes a false statement or fails to disclose the falsity of any information in a real estate transaction. We have not seen a case under this statute applying to loan transactions, but consider whether an individual might have any liability for a loss if false representations were made in the loan application process.

3.7. Consideration. As part of the review and new documentation, make sure that independent consideration has been given for any modification. As with ordinary contract principles, an agreement to do what the borrower was already obligated to do [i.e., pay interest and principal] is not valid consideration. See, Wehmeyer v. Domingues, 286 S.W.2d 194 (Tex. Civ. App.-- San Antonio 1956, no writ). When the parties to a promissory note which is matured, but not barred by the statute of limitations, agree to an extension of time for the payment of the note to a future date, new consideration arises between the parties. Each of the parties obligates themselves to the other in a manner not contemplated by the contract arising from the original note. The lender impliedly promises to give up its present right to seek immediate payment and withholds filing suit and the maker of the note impliedly promises to pay the obligation on the new maturity date. McElwee v. Est. of Joham, 15 S.W. 3d 557 (Tex. App. B Waco, 2000, no writ). See also, McCallum Highlands, Ltd. v. Washington Capital Dus, Inc., 66 F.3d 89 (5th Cir. 1995).

3.8. Usury. It is not the purpose to discuss all aspect of usury in loan transactions. However, in workouts, pay careful attention to the rules of Alamo Lumber Co. v. Gold, 661 S.W.2d 926 (Tex. 1983) and Laid Rite, Inc. v. Texas Industries, Inc., 512 S.W.2d 384 (Tex. Civ. App. - Fort Worth 1974, no writ).

a. Assume a Loan. A lender may not require a borrower to assume another's debt as a condition to making a loan. Actually, you can do that, but you have to add the assumed balance into the interest calculation. In the Alamo example, the lumber company required Mom to assume her son's open account debt as a condition to renewing a note to her.

b. Requiring Collateral for an Existing Loan. There has been no reported cases extending Alamo to situations where a lender required additional collateral for an existing debt. For example, getting a pledge of personal property from a third party to secure the existing note. But, this assumes there is no credit being extended to the pledgor.

c. Requiring a Guaranty for an Existing Loan. There has been no reported cases extending Alamo to situations where a lender required a personal guaranty of an existing debt, when no new loan was being made to the guarantor. For example, as a condition to renewing a corporate note, requiring the shareholder to sign a guaranty agreement should not create an Alamo situation.

d. Trouble Spot. What happens in complex transactions where there has been a series of notes to multiple related entities with cross-pledges and guaranties? Be careful that the transaction doesn't end up in an accidental Alamo situation.

3.9. Deed in Lieu of Foreclosure.

a. What is it? If the Supreme Court ruled that there is no such thing as a deed in lieu of foreclosure, why do we keep talking about them? See, Flag-Redfern Oil Company v. Humble Exploration Co., Inc. 744 S.W. 2d 6 (Tex. 1987, rehearing denied). When the Flag-Redfern case was decided, it caused quite a stir when it held that **there is no such thing as a deed in lieu of foreclosure**. The Court saved the day for the attorneys by allowing an equitable right of foreclosure in order to preserve the lien priority.

Technically, a deed in lieu of foreclosure does not "foreclose" anything. It merely pays the debt by the value of the property. Why use a deed in lieu of foreclosure? Sometimes a borrower wants to keep his name out of the press and his credit report clean. Rather than see a foreclosure posting, the borrower agrees to "sell" the land for the debt. The trouble with this approach is any intervening creditors remain. If it is real important to not foreclose, consider buying [or requiring the borrower to pay for] title insurance.

By having a "friendly" foreclosure you eliminate the difficult take over steps following a foreclosure. Review the mortgagee policy of title insurance when you consider a deed in lieu of foreclosure. The policy continues for a lender only under the conditions stated in the policy, which do not include a voluntary conveyance.

b. Caution. However, it is not always true that a deed in lieu of foreclosure transaction is easier, simpler or faster than a foreclosure. In a foreclosure situation, you control the time frames and deadlines. Sometimes a borrower will talk about a deed in lieu of foreclosure arrangement as a means of dragging things out.

c. The Involuntary Deed in Lieu of Foreclosure. In preparing for a foreclosure years ago we discovered a deed in lieu of foreclosure in the real property records. After investigating, we discovered that the borrower has simply conveyed the land to the lender in full satisfaction of the debt. This came as a tremendous surprise to the lender, as they were planning to seek a deficiency. Kent v. Citizens State Bank, 99 S.W.3d 870 (Tex. App. B Beaumont, 2003, no writ).

d. If you are going to use a Deed in Lieu of Foreclosure, be sure to incorporate the provision of Texas Property Code ' 51.006. Basically, the holder of a debt may void a deed in lieu of foreclosure if the debtor fails to disclose liens. Your agreement must fully incorporate the terms of Section 51.006 if you are going to be able to rely on those protections later.

3.10. Co-Guarantor Liability. The doctrine of contribution applies to multiple guarantors. If one guarantor is the "deep pocket" and the other guarantors are not, the deep pocket guarantor can pay the entire outstanding debt liability to the creditor. The deep pocket guarantor can then seek recovery from his non-paying co-guarantors, but only to the extent of their respective shares of liability. The payment may be enforced by an action of implied assumpsit for contribution. *See*, Tex. Bus. & Comm. Code ' 34.04 (b)(2) (Vernon 2002).

3.11. Sarbanes-Oxley. Loan workouts involving a public company or one of its subsidiaries may require consideration of some of the provisions of the Sarbanes-Oxley Act of 2002 ("S-OX"). In particular, if the workout involves a material change in the company's financial condition, there may be a reporting obligation. Keep in mind that there may be other implications brought about by S-OX. If you are in house counsel and get a phone call from the company's outside auditors, remember that the information you provide about the workout transaction may become part of an SEC filing. Failure to characterize the transaction properly or providing inaccurate or misleading legal analysis may expose the attorney to a violation of SEC rules for improper influence. (15 U.S.C. 7242). Additionally, if the workout is part of an off balance sheet / special purpose entity transaction, other provisions of S-OX may be triggered. (15 U.S.C. 78m). From the lender's perspective, the S-OX provisions may also impact the lending institution's practices.

3.12. *Anti-Deficiency Rules of Foreclosure.* When advising loan officers of their remedies if the workout negotiations are unsuccessful, remember the anti-deficiency statute Section 51.003 of the Texas Property Code. It provides that if the price at which the real property is sold in a non-judicial foreclosure sale is less than the amount of the debt secured by the real property, an action to recover the deficiency must be brought within two (2) years of the foreclosure sale (Tex. Prop. Code ' 51.003 Vernon 1995). Also, the defendants have the right to have the court determine the "fair market value" of the property, as set forth in the statute. To avoid the risk of foreclosing and then having a court find a high fair market value [that could eliminate a deficiency], some lenders prefer to seek a judgment first, then foreclose. Notice the statute is limited to deficiency collection suits post-foreclosure.

3.13. *Farah.* If you've never read the Farah case, look it up at State National Bank of El Paso v. Farah Manufacturing Co., 678 S.W.2d 661 (Tex. App.-- El Paso 1984, writ dismissed). Following the Farah case, there were many state and national articles on the then "newly emerging" area of lender liability law. With great injustice to a very difficult case, the essence was a letter from the lender threatening Farah Manufacturing not to allow Mr. Farah to serve as the President. The directors agreed, another president was elected, the company went downhill, Mr. Farah regained power, rescued the company, and then sued. The Court used the legal theories of fraud, duress, and tortious interference to award \$18 million in damages against the bank.

Perhaps the keynote comment from the opinion is the conclusion that while the bank "may have been acting to exercise legitimate legal rights ... [the bank's] conduct failed to comport with the standards of fair play." Farah at 690. There is also a lot of speculation surrounding the Farah case that the company was not in default at the time the threatening letter was sent.

What are the lessons from Farah? First, make sure you know what your rights are before you act. Second, unless you actually intend to use a remedy, do not make vague threats as a means of "strong arming" the other side. And, third, count to ten first, take two aspirin, and see how things look in the morning.

3.14. *Acceleration/ Waiver by Prior Actions.* Pay close attention to the situation of an installment debt which the lender accelerated, but decides to reinstate prior to foreclosure in the context of a workout. How should the lender treat the installments which the borrower makes to "reinstate the loan"? If the debt is treated as accelerated and fully matured, make sure that the loan documents to reinstate the loan reflect that the payments are credited to the debt and that the reinstated debt relates back to the original lien date. This approach will require paying close attention to make sure no intervening liens have attached to the collateral in the interim.

3.15. *12 U.S.C. ' 1001(a).* Many people went to jail as a result of false statements made to federally insured institutions in connection with a loan. Notice how on almost every loan application, there is a statement that the application is given under penalties of Title 12, 1001(a). Be sure to counsel your borrower clients about this early in the process. Losing the property and money might not be the "worst case scenario" if they end up with a criminal record. While people who have not been to "Club Fed" might think it was a picnic, those who got caught up in the web didn't think it was so great.

3.16. Lien Renewals. The renewal and extension of a matured existing note (secured by an existing deed of trust) by a new note and deed of trust is to effect a merger of the existing note and deed of trust lien into the new note and deed of trust. The holder of the new note acquires the rights of the original owner of the note. Cadle Co. v. Caamano, 930 S.W.2d 917, (Tex. App. B Houston (1st Dist.) 1996, no writ).

3.17. Appraisals. If the workout negotiations include a requirement that the lender obtains an appraisal on the collateral, confirm that the lender does in fact obtain the appraisal. The lender should decide, in advance, the conditions on which the appraisal will be revealed to the borrower. In the unpublished Teague case, as part of a loan negotiation, the lender ordered an appraisal of the real estate. The appraisal came, but the bank would only tell the borrower that it would “like the number”. The bank apparently considered the first appraisal too high and so it ordered another one. The loan renegotiations stayed “on hold” for over two months while the second appraisal was prepared. The borrower considered the appraisals to be the only missing elements of the workout and the lender would not divulge the appraisal results. About a month after the lender got the second appraisal, the borrower got a phone call that the bank planned to foreclose. The borrower responded with an application for a temporary injunction. NCNB Tex. Nat’l. Bank v. Teague Industries, Inc., 1991 WL 104024 (Tex. App. B Dallas 1991, unpublished opinion).

3.18. Power of Attorney. Be careful when a party using a power of attorney signs on behalf of another borrower in a loan workout. In the Harmon case, the wife signed a second loan modification for her hospitalized husband. The husband later claimed that he knew nothing of the second modification. In particular, his wife filed for divorce after his release from the hospital and included a TRO which prevented him from contacting her for any reason. Harmon v. Bank of West, 2003 WL 1564826 (Tex. App. B Ft. Worth 2003).

3.19. Define Authority of Parties. Use caution in what is said by the loan officer during negotiations. Courts have held that the relationship between a bank and its customers does not generally create a special or fiduciary duty. Manufacturers Hanover Trust Co. v. Kingston Investors, Inc., 819 S.W. 2d 607, 610 (Tex. App. -- Houston [1st Dist.] 1991, no writ).

A special relationship between the parties can “be established by extraneous facts and conduct such as a lender’s or bank’s excessive control over or influence in the customer’s or borrower’s business activities” (citing Farah) Martinez v. Security State Bank of Pecos, 2001 WL 842090 (Tex. App. BEI Paso 2001, unpublished opinion).

Be careful also when a loan officer in negotiations with a borrower makes statements such as “it’s a good deal” especially when the bank has contrary information, like an appraisal. (Berry v. First Nat’l Bank of Olney, 894 S.W. 2d 558 (Tex. App. B Ft. Worth 1995, no writ). Sometimes a bank officer’s statement to the borrower (as part of a loan modification) that he “would take care of me [borrower]” can be misconstrued. Martinez v. Security State Bank of Pecos, 2001 WL 842090 (Tex. App. -- El Paso 2001, unpublished opinion).

In negotiations, be clear that if a party, such as a bank officer does not have the decision making power on an issue that this limit is conveyed to the borrower. This approach will defeat an argument (at a later date if negotiations are unsuccessful) that the other party believed the officer had

apparent authority. See, Streetman v. Benchmark Bank, 890 S.W. 2d 212 (Tex. App. B Eastland 1994, writ denied).

Finally, keep in mind that there may be parties (other than the borrower) that will argue that they are relying on the workout, especially if the workout ultimately isn't successful. In Randle v. NCNB Nat'l. Bank, 812 S.W. 2d 31 (Tex. App. B Dallas 1991, no writ), the borrower met with the bank officer and following the meeting claimed to have the impression the loan default would be resolved and the bank wouldn't foreclose. The borrower told those persons it had sold portions of the property to by contracts for deed that the bank would not be foreclosing. The workout ultimately did not come to fruition and the bank foreclosed. The borrower claimed it had detrimentally relied on the meeting with the bank officer. The appellate court determined found that no rights were changed based on the meeting with the bank officer.

Counter-Claims. Also consider that in filing a lawsuit, the statute of limitations is waived on counterclaims that are promptly filed. Be sure to review the file and warn your client to expect the worst. If you are representing the defendant, be sure to ask if there are any old claims that can be plead now before the small window closes. Better to hear that before filing suit than as an explanation to a multimillion dollar suit. Tex Civ. Prac. & Rem. Code ' 16.04 (Vernon 2002).

Section 4: Preparation for a Workout

4.1. Document Review. While any [and every?] workout varies, depending on the unique facts, the best starting point is a careful and thorough review of the file.

a. **Note, Collateral Documents, and Guaranty.** We used a standard file review letter to inventory every loan document in the lender's collateral file. It is important to verify these documents against the lender's loan approval memorandum, because the workout officer typically did not generate the loan. We wanted to make sure that when we gave advice based on documents presented to us, we would be protected against claims arising later with subsequent information.

b. **Loan Documents.** After you've made sure that you have all of the documents, review them as though you were making the first advance under the Note now. For example, (1) is the legal description correct, (2) are all signatures filled out properly (i.e., the president of the corporate general partner of the limited liability company as manager of the limited partnership), (3) do the signatures match, (4) are the documents correctly recorded, and (5) are all necessary elements of perfection are complete? Also, are there any statute of limitation issues that have already run [or are about to in the next few weeks]?

If you can find and correct any problems early, you can get past any preference periods. If you represent the borrower, be sure to do the same, so you don't accidentally allow a lender to cure a perfection problem that could be used to your advantage.

Make sure the collateral documents correctly describe the debt to be secured. If you are relying on an all other indebtedness clause, does the maker match the dragnet language of the mortgage? In the olden days, we discovered that a printed form deed of trust for an affiliate bank [pre-branch banking days] had several lines dropped by the printer. Unfortunately, it was from the

all other indebtedness clause and basically no other indebtedness was secured by the deed of trust. Whenever this came up, this loan was a immediate "renewal" candidate so we could correct the mistake.

c. ***Current Updates on Title.*** Order an Abstractor's Certificate and UCC Search as part of your collateral review. Things can change from the date of the title policy and the time of review. For example, we spent a lot of time reviewing a file, preparing an inventory of collateral documents, and preparing for a foreclosure. We could not find a title insurance policy in the file. As part of the preparation for the foreclosure, we asked for an abstract report from the local title agent. We learned from the title company that the deed of trust had been released. The banker later confirmed that the local office had accepted a partial payment for the release that was not in our file. Make sure you start with the best information and your client agrees with your assumptions.

Also, on UCC files, be sure the debtor has not changed its name from the date of filing.

d. ***Taxes and Insurance .*** Confirm that property tax payments are current and that insurance on the collateral is in force. If the borrower is not paying the lender, there is a likelihood that these other property associated expenses may not be current. If the distressed loan involves an individual guarantor, has the lender determined if there are any federal tax liens against that individual's assets?

e. ***Authority of Parties.*** Order current certificates of existence and good standing for the entities to the transaction and make sure you have copies of the organizational documents. Also, for loan participations, make sure that you know if any other parties need to approve any modifications. Make sure that all of the parties who are primary obligors are properly identified and involved in the negotiations. For instance, it is standard practice that if a husband and wife signed the original note and lien, they should be signing the workout documents. What about the situation where the children are also included as grantees on the property on which the husband and wife placed the lien, but the children did not sign the original note or lien documents or any subsequent loan modifications? See Cannon v. Texas Independent Bank 1 S.W.3d 218 (Tex. App. BTexarkana 1999, writ denied).

e. ***Value of the Collateral.*** As obvious as this seems, make sure that your client [whether the lender or borrower] has verified the current, actual, honest-to-goodness, what it will sell for value of the collateral. For example, a loan officer wanted to foreclosure on a Steak House Restaurant [not the real name]. The security agreement covered things like leasehold improvements, dishwasher, ice machine, stoves, stainless steel serving lines, etc. The officer was convinced that the collateral was valuable, after all it was very expensive to buy. But, after calling auctioneers, several companies wouldn't even bid on the job and the ones that did estimated that the fees would exceed the net proceeds.

f. ***Other Reports, Data, Etc.*** Depending on the file, you might need a survey [or an updated survey if improvements were completed], environmental reports, property condition reports, financial projections, among other things. Think about the nature of the improvements in determining additional information to review. For example, if the collateral is an apartment building, do you have the latest rent roll and / or copies of the leases? This is the last time to learn whether

you have a race horse or a dead horse before your fees start adding up.

4.2. Certificates. When the original loan is funded, the lender usually gets a series of warranties and representations from the borrower regarding the collateral's condition. These representations address issues such as environmental, litigation and title. Between the time of the original loan funding and the time of the workout, there is a strong likelihood that at least some of these conditions may have changed regarding the collateral. For example, if the borrower has not been successful in making its loan payments, there is a strong likelihood that it may not have been maintaining all of its insurance coverages. While the lender's loan administration department might have been provided with notice of the changed insurance coverages, it may not have been conveyed to the loan officer who is working on the workout. Unless the borrower is required to make affirmative representations, it has no incentive to reveal the insurance issue. The same concept applied to the borrower's having delayed ordinary maintenance like roof repairs.

4.3. Junior Lienholders. As part of the initial review of the loan documentation, identify whether there are senior or junior lienholders to the debt subject to the workout. Confirm whether there are notices to, or consents which need to be obtained from, the other creditors. Is there an intercreditor or subordination agreement which governs these rights? A senior lender's actions in a workout may adversely affect the junior lienholder. For instance, if the junior lienholder is relying on the equity in the property, it would not want the senior lienholder to increase the amount of the first lien loan amount or increase the interest rate. The junior lienholder's documents may also be cross-defaulted with the senior debt. A junior lienholder, if not participating in the workout, may decide to foreclose on the borrower and take control of the collateral to frustrate the senior lienholder. Alternatively, if the workout involves the junior lienholder's lien only, the senior lienholder may try to cap the maximum amount of the junior debt or some other debt ratio maximum.

Section 5: Drafting the Workout Agreement

5.1. Conditional Releases. The RTC created a new form of release in the 1990, the "Conditional Release." Under this process, the person seeking a discharge of debt had to submit a multi-page affidavit covering every possible detail of his or her financial dealings, including airplanes, boats, gifts, transfers, etc. Then the Settlement Agreement conditioned the release and forgiveness of debt expressly to the financial disclosures. The RTC further reserved the right to set aside the release if the disclosures were incorrect, but the debtor's release was not cancelled.

5.2. Cross-Collateralization. Because of a decline in the value of the collateral, the lender may require additional collateral to secure the outstanding debt. Be careful to scrutinize this collateral from a due diligence perspective in the same manner as if it were part of the initial collateral to be used for the loan. Also, keep in mind that the pledged collateral may already be pledged for another debt.

5.3. Standstill Agreements. Suppose the loan is in default and the borrower can't raise an investment from the limited partners if the lender will foreclose. The lender is willing to wait and let the borrower reorganize things, if the money is invested. When the workout involves several conditions on the borrower, consider a Standstill Agreement. A sample agreement is attached as

Exhibit "B". This document acknowledges the defaults, clearly outlines the borrower's conditions and requires the lender to "standstill" [or not take action] so long as the borrower is not in default under this agreement. These are usually short term arrangements where the borrower agrees to refurbish the office, hire a new manager, or change the concept/name. The lender agrees to accept less cash during this time period- so long as the borrower is fulfilling its promises. While the Standstill or Forbearance Agreement will be customized to the particular transaction, remember to consider issues such as: (i) does the lender want additional or more frequent financial reports? (ii) does the lender want additional rights to review the borrower's books? (iii) does the lender want the right to bring its own consultant in to review the financial records or get an accurate determination of the collateral's value during the forbearance period?

5.4. Releases. We said earlier that asking for a full settlement as a condition of negotiations was a bad idea. However, if the parties reach a settlement, be sure to get a full waiver/release as part of the deal. Exercise care and caution, however, in drafting the release provision. A Houston case emphasized that to effectively release a claim, the releasing instrument must "mention" the claim to be released. Any claims not clearly within the subject matter of the release are not discharged, even if those claims exist when the release is executed. The court further noted that a "court should construe a contract by considering how a reasonable person would have used and understood such language, considering the circumstances surrounding its negotiation and keeping in mind the purposes which the parties intended to accomplish by entering into the contract". Baty v. Protech Insurance Agency, 63 S.W.3d 841 (Tex. App. -- Houston [14th Dist.] 2001, writ denied).

PRACTICE TIP: Do not try to be too clever in "hiding things" or being obtuse in drafting the release language for the workout. Be clear and specific in the points or matters which you are including in the release and the ones which are being reserved.

5.5. Drafting the Workout Documents. Because each workout is unique, there is no one standard set of documents that fits in all situations. For example, in addition to the main workout document, there may also be a new promissory note, a guaranty modification, a letter of credit as additional collateral, an amended partnership agreement (if the borrower had to add more partners as a credit enhancement). We have already suggested some pre-negotiation documentation and there may be intermediate memorandums or term sheets. When the parties have agreed to all the deal points, it should be described in a separate agreement which may be characterized as a "workout agreement", restructuring agreement", "settlement agreement", "compromise agreement", or "lease modification". Regardless of how it is titled, some document drafting tips are in order:

A. Beware of Unresolved Issues (no matter how seemingly small). An unresolved minor issue can lead to big consequences. Castroville Airport v. City of Castroville, 974 S.W.2d 207 (Tex. App.-- San Antonio 1998, no writ). In Castroville, the settlement memorandum referenced that the amended lease would be in the form attached as an exhibit "with **minor** revisions to be agreed to by the parties". The court interpreted this provision to be "some indication that the parties contemplated further negotiation at least with respect to some minor revisions". The tenant testified that he never intended to be bound by the settlement memorandum absent a final written agreement. The court found that the testimony raised a fact issue as to whether the parties intended their agreement to be conditioned upon the execution of a formal written lease. The court further noted that for an agreement to be enforceable, the parties must agree to all material terms. If an essential

term is left open for future negotiation, the contract is not binding.

B. ***Incorporate the Workout Terms.*** It is important to incorporate the workout terms into the loan documents. Otherwise you might create a “free standing” document which doesn’t incorporate the loan default terms). *See, for example, Ghidoni v. Stone Oak, Inc.*, 966 S.W.2d 573 (Tex. App. -- San Antonio 1998, writ denied).

C. ***Beware Documents Attached as “Forms”.*** Sometimes as part of loan modification negotiations, the parties in an effort to accelerate the negotiations and documentation will attach form documents such as notes to the term agreement for the modification. In *Seaborg Jackson*, the attached note forms provided for nonrecourse while the bank claimed that the term letter agreement did not contemplate the elimination of recourse liability. *Seaborg Jackson Partners v. Beverly Hills Savings* 753 S.W.2d 242 (Tex. App. B Dallas 1988, no writ).

D. ***Remember Basic Contract Modification Principles:*** A “modification must satisfy the elements of a contract: a meeting of the minds supported by consideration.” *See, Hathaway v. General Mills*, 711 S.W.2d 227 (Tex. 1986).

E. ***Make Sure that all the Workout Documents are Executed Contemporaneously.*** Pay particular attention that if a new loan guaranty is signed, it is signed simultaneously with the other workout documents. A recent case reminds us that to avoid an argument that a guaranty fails for lack of consideration, the guaranty should be signed contemporaneously with the other operative documents. *Windham v. Cal-Tim, Ltd.*, 47 S.W.3d 846 (Tex. --Beaumont 2001, pet denied).

F. ***Make Sure that all of the Workout Documents reflect the Negotiations.*** For instance, if there is an assumption agreement and a modification agreement, make sure that the limits of liability are the same in both documents. If they are not, the parties (most likely the borrower) will be asking the court to “harmonize” them as in the case of *S3 TX 03 L.L.C. v. Moore*, 1998 WL 3630 (Tex. App. B Dallas 1998, unpublished opinion).

G. ***Secure Representations.*** The workout is an opportunity to confirm and receive various representations from the borrower. For example, if there have been previous disputes over non-financial issues which have not been previously resolved, get a representation in the workout. Since a delinquent tax bill can ruin a workout, take the opportunity to get a representation that all of the taxes have been paid.

H. **Practice Tip:** If one of the workout documents is a new deed of trust, remember that effective January 1, 2004 Section 13.002 of the Property Code has been amended to provide that the first page of deeds, deeds of trust and mortgages must include the following required notice:

NOTICE OF CONFIDENTIALITY RIGHTS: IF YOU ARE A NATURAL PERSON, YOU MAY REMOVE OR STRIKE ANY OF THE FOLLOWING INFORMATION FROM THIS INSTRUMENT BEFORE IT IS FILED FOR RECORD IN THE PUBLIC RECORDS: YOUR SOCIAL SECURITY NUMBER OR YOUR DRIVERS LICENSE NUMBER.

Section 6: Post Workout Considerations. Signing the documents and recording them is not necessarily the end of the workout process. There are some additional issues to consider.

6.1. Communicate the Deal. Make sure that the borrower, management company and accountants who will be trying to keep "track of the numbers" have a copy of the workout documents and, more importantly, understand the deal. An unpublished Dallas Court of Appeals opinion shows the confusion (even resulting in attorneys sending demand letters for late payments referencing incorrect rental amounts) when the property manager did not understand a retroactive reduction in rent as part of a workout. Ferguson v. Mellon Bank, N.A., 1994 WL 197078 (Tex. App. - Dallas 1994).

6.2 Impress on the Client to Keep Good Records Post-Workout. Keep in mind that if the borrower has gone into financial difficulties once and the economy continues in a slump, there is a strong likelihood that the borrower will not be able to fulfill its obligations under the workout. A San Antonio case provides an illustration. Stucki v. Noble, 963 S.W.2d 776 (Tex. App. -- San Antonio 1998, writ denied). The landlord and tenant entered into a settlement and the tenant signed a promissory note. The tenant subsequently defaulted and could not pay the remainder of the note. The landlord had drafted the settlement agreement in such a manner that it preserved both the promissory note remedies and the lease's default provisions. The tenant, on the other hand, had poor records to evidence any payments that he had made since the workout. See also Hillhaven, Inc. v. Care One, Inc., 620 S.W.2d 788 (Tex. Civ. App. -- San Antonio 1998, writ ref'd n.r.e).

PRACTICE TIP: When the closing binder for the workout documents is sent to the client include a letter that not only references the transmittal of the documents, but also outlines the specific changes which accountants and managers should include in their records.

6.3. Timing Before Foreclosure Day. Remember that sometimes workout negotiations can go "down to the wire" before the time for foreclosure. In some larger lending institutions, the workout department and the foreclosure department may not be near each other geographically or have systems in place to immediately communicate that a workout has been achieved. The result of such a situation can be disastrous for the lender. If the workout negotiations are closing in on the time for foreclosure, make sure that the trustee is alerted of the nature of the negotiations and have the trustee check with the loan officer before conducting a foreclosure. Alternatively, some lenders have a policy of ending workout negotiations forty eight or seventy two hours before the first Tuesday to prevent this issue.

Section 7: Summary. Loan workouts afford a business alternative to going to the courthouse and still achieve a "win/win" outcome for both the borrower and creditor. They often require a level of detail, organization and negotiating expertise learned from the loan workouts of the late 1980s. With patience and an understanding of the motivations of the various parties involved, the loan workout becomes an economical compromise to the exercise of legal remedies or bankruptcy. Finally, as an aid to helping the practitioner involved in a loan workout to quickly review and organize the issues discussed in the paper, a workout checklist is attached as Exhibit "C".

N:\KMK\Client\BAR\MLI 2003\Speech.10.wpd

EXHIBIT "A"

NEGOTIATION AGREEMENT

Date:

Lender:

Borrower:

Note: Dated *, for executed by Borrower and payable to Lender

Guarantor:

Borrower has requested that Lender meet regarding the status of the Loan. Lender is willing to do so, but only with the understandings set forth below.

1. We all agree that, any statements, whether written or oral, made at any time after the execution of this agreement in connection with the Loan by any party is privileged and, without exception, constitute settlement negotiations that are not admissible as evidence or subject to discovery in any administrative or judicial proceeding.
2. We further agree that all meetings on this date or any time thereafter are for the purposes of settlement negotiations and that the discussions, correspondence or any other matter between the parties cannot be introduced for any purpose by any party against an other party in any litigation.
3. Any amendment to this agreement must be in writing, executed by all parties, and expressly refer to this agreement.
4. Our attorneys have been instructed that these are our agreements. Any party may terminate this agreement, upon written notice actually received by the other party, or its counsel. Any such termination shall not affect the prior discussions.
5. Borrower represents that they have discussed this with their legal counsel.

ADD SIGNATURES

EXHIBIT "B"

STANDSTILL AGREEMENT

Date:

Lender:

Borrower:

Guarantor:

The parties to this Standstill Agreement (the "Agreement") agree as follows:

BACKGROUND

- A. Borrower and Lender are parties to a _____ Agreement dated as of ____ (the "Loan Agreement").
- B. Borrower has disclosed certain defaults, as set forth herein.
- C. It is the desire of Borrower and Lender, subject to the following terms and conditions, to defer remedies based on such defaults and for this purpose are entering into this Agreement.

AGREEMENT

The parties for valuable consideration, the receipt of which is acknowledged, agree as follows:

- 1. All terms which are defined in the Loan Agreement have the meaning therein if used in this Agreement, unless this Agreement explicitly provides otherwise.
- 2. Additional Definitions:
 - a. "Defaults" means the defaults under the Loan Agreement, as set forth on Schedule I.
 - b. "Standstill Period" means the period from the Date through _____ or upon a Standstill Default.
 - c. "Standstill Default" means [INSERT LENDER'S TERMS THAT NEED TO BE PROTECTED DURING THE STANDSTILL PERIOD, such as a default as defined in the Loan Agreement that has not been disclosed]
 - d. "Standstill Covenants" means [INSERT LENDER'S CONDITIONS THAT MUST BE MET IN ORDER TO WAIT, such as payment of a judgment, adding inventory, paying some additional rent in addition to current rent].

3. Regular Meetings: Lender and Borrowers agree that their representatives will meet at the Lender's office in the months of March, June, August, and December 200_.
4. Expenses: All reasonable expenses and fees incurred by Lender, including reasonable fees and expenses of its attorneys and other advisers ("Expenses") with respect to the preparation, administration and enforcement of this Agreement will be "expenses" under Loan Agreement. Borrower agrees to pay to Lender on demand.
5. Loan Agreement: Except as expressly permitted by this Agreement, the Loan Agreement continues in full force and effect and Borrower must comply with each provision thereof during the Standstill Period.
6. Remedies: Upon the occurrence of a Standstill Default, Lender's remedies include without limitation, the right to terminate the Standstill Period and the right to terminate the Standstill Agreement generally, and in either or both events, all Defaults previously waived will be defaults upon which Lender may take any action permitted under the Loan Agreement. In addition, Lender shall have all remedies provided for in the Loan Agreement, as amended, and any other remedies provided in law or in equity, this provision not being any limit thereon. The exercise of any remedy will not be exclusive of the right to exercise any other remedy, except as required by applicable law.

ADD SIGNATURES

EXHIBIT "C"

WORKOUT CHECKLIST

I. Review of Existing Documentation

A. Loan Documentation:

1. Promissory Note

- a. Maker:
- b. Date:
- c. Original Principal Amount:
- d. Current Holder:
- e. Assignment :

2. Deed of Trust

- a. Grantor :
- b. Beneficiary:
- c. Trustee:
- d. Date:
- e. Recording Info: Volume: _____,
Page : _____, County: _____
- f. Has lien matured:
- g. Assignment:

3. Loan Agreement

- a. Borrower:
- b. Date:

4. Security Agreement / Financing Statement

- a. Secured Party:
- b. Debtor:
- c. Date:
- d. Filing Info:
- e. Expiration of Financing Stmt:

5. Guaranty (ies)

- a. Guarantor:
- b. Date:
- c. Limits:

6. Assignment of Rents

Date:

7. Participation or Servicer Agreements

Date:

Servicer:

8. Intercreditor Agreement

Date:

Creditor #1:

Creditor # 2:

9. Attorney Opinion Letter

10. Amendments or Modifications of Note and /or Deed of Trust

a. First Amendment:

Date:

Recording Information:

Vol. _____ Page _____ County _____

Purpose of Amendment:

11. Junior Creditor: Yes: _____ / No: _____

a. Creditor's Name:

b. Date of Note:

c. Amount of Note:

d. Deed of Trust B Date : _____

Recording Information: Vol. _____, Page _____

12. Senior Creditor: Yes: _____ / No: _____

a. Creditor's Name:

b. Date of Note:

c. Amount of Note:

d. Deed of Trust B Date : _____

Recording Information: Vol. _____, Page _____

B. Original Collateral Documentation

1. Mortgagee's Title Policy

2. Survey(s)

3. Appraisal
 4. Leases on Property
 5. Environmental Reports
- C. Correspondence
1. Letters of modification, negotiation or previous demand letters
 2. Phone Message slips
 3. E-mails
- II. Confirm Nature of Default
- A. Monetary
 - B. Non-Monetary
- III. Update Collateral Information
- A. Financial Statements of Borrower / Guarantor Title Update
 1. Review Other Financial Obligations of Borrower / Guarantor
 - B. Title Update
 1. Watch for second liens, tax liens, assessments and need to notify same
 2. Need to notify other parties with interest in collateral?
 - C. Environmental Update
 1. Review current use of property including tenants if an improved commercial property.
 - D. Property
 1. Any Partial Releases?
 2. Has Property Been Replatted?

- E. Guaranty
 - 1. Still Valid (i.e., has amount guaranteed been paid ?)
- IV. Update Outstanding Amounts Owed to Creditor
 - A. Outstanding principal amount of loan / note
 - B. Confirm delinquent amounts
 - C. Have taxes and insurance been paid current?
 - D. Existing Non-Monetary Obligations
- V. Interview Persons Involved
 - A. Loan Officer
 - B. Property Managers
- VI. Update Confirm Current Contact Info / Addresses
 - A. Primary Obligors
 - B. Guarantors
- VII. Confirm No Bankruptcy Filing
- VIII. Preparation of Workout Documents
 - A. Preparation of Basic Documents
 - B. Preparation of Ancillary Documents (include corporate authorizations)
 - C. Summarization Letter of Key Terms to Client

EXHIBIT "D"

Loan Workouts - Bankruptcy issues By Diane G. Reed

The Problem: The Borrower is on the verge of bankruptcy; wants to try one desperate measure (give the lender anything to stop the foreclosure) but probably won't be able to avoid bankruptcy in the long-term. Should the Lender do the workout and take the offered payments/guarantees/collateral? What will happen to the value if the Borrower's last desperate measure fails? Will the transfer(s) to Lender be unwound in bankruptcy court? What can you do prospectively to protect the Lender from avoidance actions?

The workout hypothetical: Borrower is a single-asset limited partnership with insufficient cash flow to meet debt service to your client. Its principals are individuals who also own interests in other entities. To avoid foreclosure, Borrower's principals will give Lender new guarantees or new guarantors and a pledge of assets owned by affiliates. How do you take all you can get from Borrower, Borrower's principals and Borrower's affiliates, without getting sued when any of these entities files bankruptcy?

Realistically, you probably don't. If Lender acts aggressively and takes new money and new collateral, Lender is likely to be sued by a Debtor or trustee in Bankruptcy. Why? Because Borrower can rarely turn its business around quickly enough to avoid bankruptcy; the bankruptcy case of Borrower or its principal or affiliate is very likely. Lender has improved its position in the workout by receiving transfers from Borrower and its affiliates. The transferors and their other creditors will want to undo the transfers to Lender. Your goal in structuring the workout is two-pronged: Avoid or delay bankruptcy if possible; but prepare to defend a preference or fraudulent transfer action.

1. Who is likely to become a Debtor in a bankruptcy case?

Following the workout, a bankruptcy case might be commenced by or against either the Borrower or an affiliate which contributed its credit or assets to the Borrower. The risk to Lender in these bankruptcy cases is that the workout transaction will be undone in a suit against Lender for recovery of either a preferential transfer or a fraudulent transfer.

A preference is by definition a transfer *to a creditor* which prefers that creditor over other creditors; a fraudulent transfer is a transfer for little or no consideration and is generally a transfer *to an entity which was not a creditor* before the transfer. Generally, if you receive a transfer from your obligor, you are at more risk for a preference claim; if you receive a transfer from an entity other than your obligor(s), you are at more risk for a fraudulent transfer claim.

Therefore, if the Borrower files for bankruptcy protection, Lender's greatest exposure is for a possible preference; if an affiliate files, the exposure will be for either preference (if the affiliate was a pre-workout guarantor) or for fraudulent transfer (if the affiliate was not previously obligated on the note, but contributed new collateral or payments).

2. Is my client Lender going to be sued for a preference? (Has my client bettered its position at the expense of unsecured creditors? If so, will a bankruptcy case be filed within 90 days?)

A preference is all about one creditor's recovery, relative to the recovery of other creditors. The Bankruptcy Code says that all creditors deserve to be treated equally when the Debtor is insolvent. If one creditor receives more than its fair share of inadequate assets, that creditor has been preferred over other creditors.

The elements of a preference claim by the Debtor or bankruptcy trustee under Section 547 of the Bankruptcy Code: (a) a transfer of an interest of the Debtor in property; (b) to or for the benefit of a creditor; (c) on account of an antecedent debt; (d) made within 90 days before the petition (or within one year, if the creditor is an "insider"); (e) made while the Debtor was insolvent (insolvency is presumed during the 90 days immediately preceding the bankruptcy); (f) which allows the creditor to receive more than it would have received if the transfer had not been made and a bankruptcy petition had been filed instead.

In a workout situation, we arrange for our clients to receive a preference; our primary goal is to have our client receive more than it would have received, absent the workout agreement. Our secondary goal is to insulate that preference from attack by the Debtor or Trustee in bankruptcy, and we do that primarily through passage of time.

The ninety day preference window is very important in structuring your workout. The transaction should always leave the Borrower with sufficient funds to continue operating its business and paying its current operational costs for at least ninety days after the transfers to Lender. If Lender is receiving new collateral, the date of perfection is the date of the transfer. If Lender is receiving a series of payments/transfers, each transfer is subject to the ninety day preference attack.

Some other preference element considerations:

§ Transfer of an interest of the Debtor in property. The "Debtor" is the entity which goes into bankruptcy, either voluntarily or involuntarily. If the Borrower files a bankruptcy case, the transfers which can be attacked are only those received from Borrower; but Lender will rarely have received anything new from the Borrower, because Lender will have already had a lien on all Borrower's assets. In the workout you will typically be taking new collateral and new value from principals or affiliates; if the Borrower then files bankruptcy, Lender has no preference exposure because there has been no transfer of an interest *of the Debtor* in property. If the principal or affiliate goes into bankruptcy, however, the Lender has received a transfer of property of the Debtor.

§ Was the transfer made within 90 days before the bankruptcy? Lender may be in a position to control this element, to some extent; but even if the Borrower does not elect to file a bankruptcy case, other creditors might place the Borrower into bankruptcy involuntarily. The general rule under section 303 of the Bankruptcy Code is that three or more creditors must file the involuntary petition and the court must enter an order for relief if it finds that the Debtor is generally not paying its debts as

they come due.

- § If the transfer was within a year before the bankruptcy, is the Lender an insider? Lender should also be aware that the “preference period” is extended to a year, if the creditor is an insider. There have been cases in which the unaffiliated Lender is deemed to be an insider, due to Lender’s exercise of control over the Borrower.
- § Was the Debtor insolvent at the time of the transfer(s) or rendered insolvent? Obviously, if the affiliates are insolvent before giving Lender the new collateral or guarantees, nothing in the workout will change that; but if any of the affiliates is solvent, the workout transactions can be structured so that the new obligor is not rendered insolvent by the transfers.
- § Did the Lender receive more than it would have received if the transfer had not been made and the transferor had instead filed a bankruptcy case? In single-asset real estate loans, the Lender will usually be secured by everything the Borrower owns, even before the workout; so, Lender can successfully argue that in a bankruptcy case, it would have received everything. Note, however, that this defense would not be available to the Lender who had some problems with its pre-workout documents that would have compromised Lender’s liens. If those problems were repaired in workout, so that the Lender “shored up” its lien position on any assets, the new liens would be avoidable preferences if the bankruptcy case is filed within the preference period.
- § If the Debtor in bankruptcy is not the Borrower, but some affiliate of the Borrower who transferred something of value to the Lender in the workout (such as a guarantee or a pledge of the affiliate’s assets), the Lender might be sued for either a preference or a fraudulent transfer, depending upon whether the affiliate was already obligated on the debt. If the affiliate was already a guarantor, and simply gave the Lender additional collateral, then the case against the Lender in the affiliate’s bankruptcy would most likely be a preference action, and the question would again be whether the transfer allowed Lender to receive more from this entity than Lender would have received if this entity had filed a bankruptcy case rather than make the transfer to Lender in the workout.
- § Even if all the elements of preference are present, the Lender may have defenses, especially (a) ordinary course of business payments; and (b) subsequent new value. It is very difficult to convince a bankruptcy court that transfers in a workout were “ordinary course of business” transfers, especially since the Borrower will have defaulted on its “ordinary course” payments pre-workout. Following the workout, however, payments on a restructured note should become the “ordinary course” of dealing between the parties.

3. Is my client Lender going to be sued for a fraudulent conveyance? (Has my client received something from any entity without giving that entity some valuable quid pro quo?)

Consider the situation where the Borrower is a single-asset entity and the lender already has a lien on everything the Borrower owns. The Borrower is owned by two individuals who also own other single-asset entities with equity in the properties. The individuals offer to pledge the assets of the other entities in exchange for forbearance as to the Borrower. They may offer to have the affiliates make payments to Lender. If the Lender accepts payment from affiliates and takes liens on the other properties, the lender has received a transfer of property of the affiliates, and the affiliates have received less than adequate consideration (i.e., nothing) for the transfers. When the affiliates file bankruptcy cases, the lender is sued for recovery of the fraudulent transfers, the lien on additional properties is avoided, and the bankruptcy trustee gets a judgment against Lender for the payments made by affiliates. Furthermore, if the affiliate has signed a guarantee as a part of the workout, the guarantee is also voided, since the affiliate received no consideration for incurring the new debt.

Under Section 548 of the Bankruptcy Code, a fraudulent transfer is a transfer of property of the Debtor within one year before the bankruptcy case for which the Debtor receives less than reasonably equivalent value, at a time when the Debtor is insolvent or is rendered insolvent by the transfer. (Texas has its own fraudulent transfer statute under which the Transfer can be attacked for up to four years, but that Statute requires actual intent to hinder, delay or defraud creditors.)

A fraudulent transfer cause of action differs from a preference in many ways, but the essential difference is this: in a preference, the creditor receives transfers from an obligor on account of pre-existing debt; in a fraudulent transfer, the transferee receives a transfer from someone (not necessarily its borrower) for less than reasonably equivalent value. Credit against a valid debt is "value", so transfers by a Borrower to the Lender could rarely be fraudulent, unless there is a scheme to defraud other creditors. Therefore, in a workout situation, a fraudulent transfer action against Lender will usually be brought in the case of the bankrupt affiliate which contributed value to the workout.

4. What can Lender do prospectively to avoid these lawsuits?

- § Keep all entities out of bankruptcy as long as possible. With time, all transfers become unassailable. Keep in mind the 90 day window for preference claims, and the one-year look-back for fraudulent transfers and insider preferences. This might mean leaving money on the table in the short-term, so that the parties and their creditors will not seek bankruptcy court protection.
- § Analyze the financial condition of each affiliate giving new value to Lender. Is the affiliate insolvent? If not, then will it be rendered insolvent by this transfer? Is there a way to get all or most of the equity, and yet not render the affiliate insolvent? A limited guarantee secured by the affiliate's property might be more valuable than an unlimited guarantee, if it leaves the affiliate solvent. If the affiliate remains solvent, there is no risk of either preference or fraudulent conveyance liability.
- § If any of the parties to your transaction is solvent, structure your workout so that transfers/payments are received from the solvent entity, because insolvency is one of the elements of either a preference action or a fraudulent transfer action.

- § If any of the parties is solvent, preserve evidence of such solvency. Get financial information and representations concerning solvency.
- § Make sure that the benefit to all entities is documented. If an entity receives the benefit of funds advanced or of forbearance, recite that benefit in the documents.
- § If Lender is extending further credit as a part of the workout, consider whether new funds can go to or for the benefit of the affiliate which is pledging new assets, thereby establishing that the affiliate has received reasonably equivalent value for the transfer; but be aware of the Alamo Lumber case cited in the main article and the possibility of usury problems.
- § Consider whether the deal can be structured so that payments come from Lender's obligors, rather than from an affiliate. Remember that the Borrower's payments on the debt are not fraudulent, but the affiliate's payments might be. It might be possible to require in the workout documentation that the payments all come from the Borrower or existing guarantors.
- § Inquire into inter-affiliate financial transactions. If the Borrower is commingling its funds (your collateral) with funds of affiliates, you are much more likely to be sued in the bankruptcy case of the affiliate.
- § Assess the risks and potential benefits with the Lender client. If there is substantial equity in the affiliate's assets, the client may want to go ahead and take the additional collateral, even with its attendant risk of later litigation. After all, the Borrower and its affiliates may be able to stay out of bankruptcy court for the 90 days to protect the preference or for the one year to protect the constructively fraudulent transfer. Lender may feel that it is better to take the new value in hopes of holding on to some or all of it.

EXHIBIT "E"

Ethical Considerations

A. **Who is the Client?** We've seen how there can be a number of parties with different interests involved in a lease workout. There is the Borrower which may be an individual, partnership or a small corporation. The Borrower's lease obligation may be guaranteed by the individual general partner or the individual shareholder of the corporate Borrower. There may be an individual lease guarantor who is related to one of the partners or a relative of the shareholder. These individuals who are in the midst of going through the grief process described earlier (and are potentially financially strapped) are not going to be cognizant of the ethical issues that an attorney faces. They refuse to understand that they all may be liable to different degrees for the various lease obligations and that their various interests may come into conflict in a lease workout. It is incumbent on the attorney to recognize the ethical issues associated with negotiating lease workouts so that the attorney is not having to "workout" things with his malpractice carrier later.

B. **Know Your Client:** Is your client an individual person, a partnership or corporation?

1. If your client is an organization, T.D.R.P.C Rule 1.12 provides, in part, A lawyer employed or retained by an organization represents the entity. While the lawyer in the ordinary course of working relationships may report to, and accept direction from, an entity's duly authorized constituents, in the situations described in paragraph (b) the lawyer shall proceed as reasonably necessary in the best interest of the organization without involving unreasonable risks of disrupting the organization and of revealing information relating to the representation to persons outside of the organization.

(b) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears reasonable necessary to avoid misunderstanding on their part.

T.D.R.P.C Rule 1.12 requires that an attorney who represents an organization owes his or her primary loyalty to the organization, and not to any individual member of the organization.

Sometimes, an attorney may be hired to represent the interest of both the organization and an individual constituent of the organization -- T.D. R.P.C. Rule 1.12 , Comment 5.

Rule 1.12(e) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interest are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears reasonably necessary to avoid misunderstanding on their part.

C. **Conflicts of Interest.** Representation of an organization and an individual associated with it may also trigger the provisions of Rule 1.06 dealing with conflicts of interest.

Rule 1.06 Conflicts of Interest: General Rule. A lawyer shall not represent opposing parties to the same litigation. In other situations and except to the extent permitted by paragraph (c), a lawyer shall not represent a person if the representation of that person:

(1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interest of another client of the lawyer or the lawyer's firm; or

(2) reasonably appears to be or become adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests;

(c) A lawyer may represent a client in the circumstances described in (b) if:

(1) the lawyer reasonably believes the representation of each client will not be materially affected; and

(2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.

D. **But He's "My Lawyer Too."** We've discussed the rules applicable when you and the person who you are representing are both in agreement that an attorney client relationship exists. What about the situation that can occur in a lease workout as follows:

The Lender calls you and asks you to represent him in the workout negotiations. You do so and contact the Borrower saying you are going to "negotiate and paper the deal on behalf of the Lender". The Borrower is an older person in the "grief cycle" described earlier and does not listen to what you tell him about who you represent. All he knows is that he's got to keep the space and realizes that he has little spare money and certainly none to afford his own attorney. Subsequently, the Lender (who is in a hurry) reviews the workout documents you have drafted and is satisfied. Pursuant to the Lender's instructions, you send the draft documents to the Borrower. The Borrower is now in the acceptance phase of the "grief cycle" and calls you to ask just a few questions "he's not clear on". The questions start innocently with confirming where he is suppose to sign and develop into "well, let me ask you this, how will my brother's lease guaranty be impacted by this workout?". On the one hand, as attorney, you know that you should advise the Borrower that he needs to get separate counsel and that you don't represent him. On the other hand, your Lender client is anxious to get this workout finished (besides, he's got limited funds to pay legal fees also). You believe that you can answer this last question of the Borrower without prejudicing your client and get the deal done. You answer the Borrower's question and three follow-ups. Does the Borrower now believe that you are now his attorney also?

E. **Merely a Scrivener or Negligent Misrepresentation**

Beware of confusion between liability to a non-client and merely acting as a scrivener for the transaction. A 2001 Corpus Christi opinion case illustrates the issue. Sutton v. Estate of McCormick, 47 S.W.3d 179 (Tex. App. B Corpus Christi 2001, no writ). The circumstances described in this case have a close resemblance to a lease workout scenario. The opinion begins by recognizing that the attorney-client relationship is a contractual relationship with the lawyer agreeing to provide professional services for a client. The opinion also cites the Roberts case noting that for the relationship to be established, “The parties must explicitly or by their conduct manifest an intention to create it. To determine whether there was a meeting of the minds, we use an objective standard examining what the parties said and did and do not look at their subjective states of mind”. Roberts v. Healey, 991 S.W.2d 873, 880 (Tex. App. B Houston [14th Dist.] 1999, pet denied).

As background, Sutton lived in Maine and wanted to buy a ranch in Texas and relocate. He contacted Attorney McCormick to help with the ranch purchase. Before closing on the ranch, Sutton learned of an ostrich rancher named Mantzel who was in financial difficulty. Mantzel flew to Maine to discuss how they might come to an arrangement to save Mantzel’s ostrich business and enable Sutton to break into the ostrich-farming business. The two men quickly negotiated a deal within twenty-four hours and called Attorney McCormick in Raymondville to draw up the paperwork.

In the trial regarding the malpractice claim which Sutton brought against the attorney, some of the testimony of the two businessmen gives valuable insight into how to avoid a similar claim:

Sutton first testified that he told the ostrich farmer that “We would have to have an attorney”. Sutton told the ostrich farmer that he (Sutton) had an attorney in Raymondville. They then called the attorney “Because I wanted Mr. McCormick to start drawing up the contracts as we had agreed to them in my living room and I wanted him to have all the information available, so that when we got down there the following day everything would be ready to sign.” The ostrich farmer was on the same phone call and dictated the terms of their agreement to the attorney’s secretary.

Sutton’s testimony continued as follows: “Well I just wanted to make sure that he would be available to create a document to protect both Mr. Mantzel and myself; primarily me, though because he did represent me. And I wanted to be sure that he understood the contents of our agreement. This seemed to be very urgent to Mr. Mantzel. Time was running out on who he had to pay this money to, and I wanted to help in that situation. And I also wanted to make sure that he understood Mr. Mantzel was going to be responsible for this”. Sutton then recounted how when he went to get a bank loan, the borrower had to pay the bank’s legal fees and “in this case [Mantzel] was going to pay my attorney’s fees that I incurred”.

The documents were prepared by the attorney and the two businessmen flew to his office in Texas and signed the documents.

Sutton later testified: “I wanted McCormick to be aware that he is drawing up this contract for both parties. Even though he is representing me, he is also wanting to protect, you know, the other party as far as the agreements that I made to the other party in terms of what I was going to perform. He told me he understood what I meant and he would most definitely protect me”.

Unfortunately the attorney died shortly after the deal. Sutton sued his estate for malpractice

and the only offered evidence of the attorney-client relationship between Sutton and the attorney was Sutton's testimony. The appellate court affirmed the jury's verdict in favor of the attorney's estate. The appellate court notes that the attorney "was unable to give testimony regarding his understanding of the agreement between himself and Mr. Sutton". The appellate court also held that "Sutton's testimony left unclear the exact parameters of the relationship between himself and Attorney McCormick". The jury may have believed that the attorney was acting as a mere scrivener or that he was "to a limited extent -- representing them both".

See also Parker v. Carnahan 772 S.W.2d 151 (Tex. App. -- Texarkana 1989, writ denied). The Carnahan case noted that "an attorney can be held negligent where he fails to advise a party that he is not representing them on a case where the circumstances lead the party to believe that the attorney is representing him".

PRACTICE TIP: Communicate to the parties in the workout and document your files to prevent misunderstandings of who you are (and are not) representing and the extent of that representation. Be especially aware of non-clients and inform them both orally and in writing that you are not their lawyer and are not seeking to advance their personal interests.

KEVIN M. KERR, P.C.

ATTORNEY AT LAW
3100 MONTICELLO, SUITE 105
DALLAS, TEXAS 75205
EMAIL: KEVIN@KKERRLAW.COM

972/ 644-3335

FACSIMILE: 214/ 219-1160

Kevin graduated from the University of Houston College of Law, in May, 1981, where he served as the Executive Editor of the *Houston Law Review*. Before law school, he graduated from University of Texas at Austin in December, 1977, graduating with honors and majoring in Finance.

ACTIVITIES

Past Chair, Real Estate Forms Committee, State Bar of Texas.

Past Chair (1993-1996), Dallas Bar Association, Real Property Section.

Member, Various Planning Committees for the State Bar of Texas and University of Houston.

Director, Advanced Real Estate Law Course (1994) (State Bar of Texas).

Moderator, Advanced Real Estate Law Course (1995) (State Bar of Texas).

Speaker/Author: Numerous articles written for real estate related legal topics, including the Dallas Bar Association Real Property Section, State Bar of Texas, South Texas College of Law, University of Texas Law School, University of Houston Law Center, and Southern Methodist University School of Law.

Former Member: City of Allen, Texas Planning and Zoning Commission

Current Member: Allen Independent School District Board of Trustees

DONALD G. HAWKES
Hawkes Law Firm P.L.L.C.
6060 North Central Expressway, Suite 560
Dallas, Texas 75206
214-747-4295
dhawkes@hawkeslaw.com

Don Hawkes is a principal in the Hawkes Law Firm P.L.L.C. His practice concentrates on real estate and commercial transactions, corporate and timber law. Prior to forming the Hawkes Law Firm P.L.L.C., Don was senior counsel for International Paper Company for ten years emphasizing a diverse range of real estate and corporate transactions. Before joining International Paper Company, he was a staff attorney for the Federal Deposit Insurance Corporation handling loan modifications, workouts and foreclosures.

He received his B.B.A., magna cum laude, from Southern Methodist University and his J.D. from the Dedman School of Law in 1983. He is licensed to practice law in both Texas and Colorado and is also a member of the College of the State Bar of Texas. Mr. Hawkes has coauthored presentations for seminars sponsored by the State Bar of Texas Professional Development Series and the University of Houston.

**DIANE G. REED, ATTORNEY
REED & REED
501 NORTH COLLEGE STREET
WAXAHACHIE, TX 75165
972-938-7334
dianegreed@sbcglobal.net**

Curriculum Vitae as of May 15, 2003

Education:

1979 - 1982

University of California at Berkeley School of Law (ABoalt Hall"), J.D.

1975 - 1979

University of Texas, Permian Basin, B.A. in Political Science.

Law Practice and Affiliation history:

1991 - Present: Diane G. Reed, P.C., d/b/a Reed and Reed, Attorneys; Sole shareholder, President and CEO. Attorney representing Creditors, Debtors, Committees and Trustees in cases under all chapters of the Bankruptcy Code; also serving as Chapter 7 and Chapter 11 Trustee in cases in Dallas and Ft. Worth, Texas. Currently administering approximately 50 "Asset" cases with total deposits of approximately \$5,000,000.00.

1987 - 1991: Sherman & Yaquinto; attorney representing small-to-medium size debtor companies in Chapter 11 and Chapter 7 proceedings; and representing bankruptcy trustees.

1982 - 1987

Gardere & Wynne, a 100-to-200-attorney firm with a full-service bankruptcy section; attorney representing creditors, creditors' committees and Chapter 11 and Chapter 7 trustees.

Professional organizations and memberships:

Original member of John C. Ford American Inn of Court for bankruptcy practitioners in the Northern District of Texas, chartered 2000.

National Association of Bankruptcy Trustees, member since 1991.

Admitted to practice in the bankruptcy courts of the Northern, Eastern, Southern and Western Districts of Texas.

Ellis County Bar Association, 1995 - present.

Dallas County Bar Association, 1982 - 1996.

Texas Bar Association 1982 - present.