Loan Restructures - Lessons from the American Debt Crisis

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Loan Restructures
Lessons from the American Debt Crisis

*Principles, Practical Issues and Strategies*

*Gerald Nels Olson*

I. Introduction.

In the twenty-two years following the abandonment of the Bretton Woods Accord by the United States, fueled by rapid technological development and increasingly interdependent world trade, a global financial economy has been unleashed. The global financial economy is approximately fifty times larger than the so-called global real economy.2

According to Joel Kurtzman, Executive Editor of the *Harvard Business Review*, “[t]he ascendancy of trading means that finance has shifted its orientation from “investing” to one of “transacting,” a consequence of the ability of computers and telecommunications network to manipulate vast quantities of information effortlessly and send it around the world. The information age has moved finance from its age-old static — even passive — framework of buying assets or making investments and holding them, into something new, making money by harvesting minute shifts in value across various exchanges.”3

The growing dominance of the global financial economy, combined with the floating rate currency exchange system which followed the collapse of Bretton Woods, and accompanied by the accelerated velocity of high-tech trading, has resulted in increasingly volatile financial markets; highs are higher; lows are lower; and cycles are closer together as a result of “hot money” and electronic “portfolio investment.” All of these developments have put tremendous pressure on the international monetary system.

Unless the increasingly destabilising and volatile effects of the global financial economy on the financial arrangements integral to domestic real economies are mitigated through international currency stabilization and trading regulation, the pernicious problems presented in resolving insolvencies, liquidations, reorganizations and effecting debt restructures will increase.

1. Visiting Senior Fellow, Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London; Associate Director, London Institute of International Banking, Finance and Development Law. The author is currently writing an extended monograph regarding distressed banks, law and public policy. The author is most grateful to his former colleagues at Winstead, Sechies & Minick P.O., who participated in the preparation of prior unpublished versions of certain materials contained in this paper.


3. *Id.*, at p. 25.
The United States has benefitted, and expects to continue to benefit, from the abandon-
ment of the Bretton Woods fixed exchange rate system through the devaluation of its inter-
national financial obligations. Because the dollar has continued to serve as the world's 
reserve currency, currency stabilization through the adoption of a fixed or semi-fixed 
exchange rate system is viewed as highly unlikely. Similarly, no nation or group of nations 
has been willing to take the lead in regulating trading in the global financial economy. 
Consequently, as pressures from the growing global financial economy increase, the world 
may expect an increasing incidence of company and bank insolvencies and increasing size 
and complexity of those insolvencies. Emerging economies are facing the brunt of this pres-
sure. As an example, following the collapse of the Mexican peso in late December 1994, non-
performing loans in Mexican banks rose from a 1994 rate of 9% of all bank loans to a 1995 
rate of approximately 17%. Under U.S. accounting standards, however, the 17% rate would 
equate to about 27%. A bank bailout program is ongoing, with the non-performing loan 
largely in the hands of banks. By the year ending March 1995, 14 Venezuelan banks had col-
lapsed. The government has not yet developed a plan to sell off banking assets that have fall-
en under state control as a result of interventions. According to the International Monetary 
Fund, "Crises in the banking systems of Argentina, Mexico and Venezuela and costly bank 
bailouts in Brazil, have raised concerns that weak financial systems may be one of the most 
important Achilles heel of the region's economic reforms." 

This paper examines the practical and legal issues addressed in the American banking 
crisis of the late 1980s and early 1990s, at the point where the author's experience inter-
sected with an awareness of the extraordinary systemic nature of the collapse of asset val-
ues, and thus debtor and bank capital, in America in the mid 1980's. 

According to Congressional testimony by Bernard Weinstein, Director of the Center 
for Economics Development and Research, "... Mexico's current financial emergency mir-
rors Texas' and then the America's S & L crisis of a decade ago. An inadequate capital base, 
rising loan losses, inexperienced management and a sky-high cost-of-funds all sound 
familiar." Despite cultural and legal differences among the Latin American countries, 
including Mexico and the United States, the causes of these financial crisis are essentially 
the same. The issues presented in their resolution at the bank asset level through loan 
restructures also are essentially the same. Indeed, "[t]he deflation visible in Mexico is part 
of a larger, global asset and revenue collapse that is apparent in Japan, China, Europe and 
in many emerging markets." 

In the United States, the deflating erosion of asset values was reflected first in debtors' 
capital. As loan defaults proliferated, both debtors and creditors sought to protect their 
balance sheets by shifting apparent losses to others through broad-based, multiparty nego-

7. Testimony of B. Weinstein, Director, Center for Economic Development and Research, 
Professor of Applied Economics, University of North Texas, before the Senate Committee on 
8. Testimony of C. Whalen, Chief Financial Officer, Legal Research International, Inc., before the 
Senate Committee on Banking, Housing and Urban Affairs, U.S. Congress, May 24, 1995.
tations of consensual workouts, foreclosures, litigation and bankruptcy, followed by widespread bank failures, rescues and bailouts. This process is distinguished from the legal and economic effects of prior boom and bust cycles, following the Great Depression in the late 1920's and 1930's and in the mid 1970's in America and worldwide. It has been said that the earlier cycles resulted in a winnowing of the weaker and less capable debtors and creditors, whose misfortune was often predicated by mismanagement, and in some cases, fraud. The recent systemic crisis of capital adequacy, however, struck both the strong and the weak, and was thus devastating in its effect.

The more astute participants changed tactics in these new circumstances. These changes were reflected by both debtor and creditor desires to resolve widespread defaults in credit transactions on a "global," "planned" or "integrated" basis, as opposed to narrow enforcement of contractual and legal rights and remedies. There was, in effect, a tacit acceptance by the more sophisticated players that the broad based economic crisis was well beyond the consequences of occasional mismanagement or fraud. Less astute participants in this growing drama, most particularly politicians and bank regulators, however, continued to view the growing number of loan defaults as a moral crisis, founded in widespread fraud and criminal activities. Tragically, the American legal and bank regulatory system has been largely limited to this perspective.9

This paper explores the dichotomy, first by examining the immediate context of the American crisis of capital inadequacy during the period 1985 to 1995, then the distinctive characteristics of the loss recognition and allocation processes between debtors and creditors which brought the systemic nature of the American crisis to light, and which is, in the most basic sense, the battle ground for debtor and creditor solvency.

In the late 1980's and early 1990's, debtors and creditors in the United States were in the grip of a systemic cycle of capital deterioration of unprecedented proportion. Superficial public and governmental opinion suggested that the current problem of capital deterioration was driven by collapsing real estate values, first in the Southwest, and then in New England, the Mid-Atlantic States and the Southeast, but that the problem did not extend to other parts of the country. The problem of collapsing real estate values, however, was pervasive throughout the United States. The effects of collapsing real estate values, however, when combined with other problems with national implications (including increasing

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9. But see, C. Whalen, who observes that "... the criminal economy ... [is] by far the largest of the three sectors of the Mexican economy, which is built around narcotics trafficking, arms smuggling, kidnapping and other forms of illegal activity. The criminal economy has mushroomed in size over the past decade and now clearly dominates the entire political economy of Mexico. By way of comparison, consider that the $25 to $30 billion in profits from the $100 billion per year narcotics trade is twice the total revenues of mexican oil sector ....

It is impossible to have sound solvent banks in an economic environment that is as hostile and difficult is the one that I have just described." Id., citing an FBI report by James Moody, head of that agency's narcotics section, Whalen notes that "companies in the process of privatization in Mexico under President Salinas were purchased by narcotics trafficking organizations in Mexico and Columbia." Id.
rates of default on LBO’s, junk bonds and other highly leveraged transactions) and regional economic problems, such as the oil and gas problems in the Southwest and sagging performance by the so-called “high tech” industry in the Northeast, precipitated broad-based credit constringion and an alarming rate of business failures, resulting in the erosion of the nation’s financial institutions’ capital footings. This process has often been described as the “deleveraging” of American business in the 1990’s.

Experience revealed recurring patterns of reaction to this crisis by both debtors and creditors. These reactions were marked by early and persistent denial of the problem. Experience has also showed that, when regulatory examiners of federally-regulated financial institutions forced recognition of the problem, both debtor and creditor management were thrown into an intractable reactionary mode. Debtors faced abrupt and precipitous termination of long-standing, historical credit relationships. Creditors were often unable to withstand against the pressure of constantly increasing and restrictive regulatory action, including the effect of regulators’ actions on their operations, the constant turmoil of resulting crisis management, the distortion on the institution’s balance sheet caused by a dramatic shift from earning to nonearning assets, increased levels of other real estate owned (“OREO”) and other repossessed collateral and the wave of litigation and bankruptcies which the repossession and foreclosure process invited, as the debtor’s ticket to survival.

The cycle of industry-wide in-substance and actual foreclosure or repossession, of collateral marking to market of collateral value mandated by accounting and regulatory policy, increasing costs to carry and manage assets and to administer problems which the creditors were inadequately prepared to manage and resolve, and the dramatic effect of negative leverage on both debtors and creditors, resulted in recurring unavoidable capital losses, unless a proactive approach was taken by debtor and creditor management early in the cycle. The mission of management was to minimize capital loss, stabilize the downward spiral of negative leverage and deflect as much loss as possible to hapless, unprepared competitors. Failure to act quickly, decisively and proactively, pursuant to a clear plan and

10. See Whalen’s observations with respect to the developing situation in Mexico and Latin America. Id. See also, Credit Crunch, the Banking Disaster in Mexico Whipsaws an Ailing Economy, W.S.J., January 25, 1996, at p. A-1. Moreover, Mexican banks have been reluctant to recognize the extent of their losses.... “Banks prefer to wait for the economy,” with the hope that growth will lift the prices of these properties again, says Pedro Azcue, managing partner at La Salle [La Salle partners].

Mexican business culture contributes, too, to the unwillingness of bank to acknowledge their mistakes and make changes. Short of a government takeover, few Mexican banks have made a major management change, though many executive teams left their banks vulnerable. Mexican boards tend not to hold managers as accountable as U.S. companies do, especially because many Mexican companies are still dominated by families.”
established priorities, resulted in the dissipation of both the debtor’s and the creditor’s liq-
uidity and capital and in the elimination of their remaining flexibility. This process of loan
workout and restructure was distinct from the usual loan-by-loan enforcement tactics gen-
erally employed in previous cycles.\textsuperscript{11}

This article examines the context for the American national crisis of capital adequacy,
describes in more detail the indicia of the problem and prescribes a proactive general pro-
gram to minimize the effect of this crisis on a given debtor or creditor by early problem
recognition; prompt, detailed and anticipatory response, accurate asset valuation, early loss
allocation and consensual balance sheet restructuring. The goal of both the debtor and the
creditor should be to recognize this problem early, deal with it in at least as favorable a
manner as the debtor’s creditors and the bankruptcy courts ultimately would require, and
take painful but acceptable losses necessary to ensure the financial survival of both debtor
and creditor.\textsuperscript{12} As we will discover, there are many more restraints on the debtors’ and
creditors’ ability to act in their mutual best interest than initially meets the eye.

\textbf{11.} See, M. Tangman, “The Once, and Future, Banking Crisis?”, \textit{Institutional Investors}, at p. 19,
November 1995. “Mexicans’ debt bind, with its potential for sparking social unrest, so worries
the government that in late August Zedillo and Ortiz presented an emergency four-point plan
to restructure bank loans. It was clearly aimed at stemming a growing tide of borrower senti-
ment for a payments moratorium, an idea first championed by rural debtors’ organization El
Barzon on 1993. The borrowers’ movement has gone urban and consumerist since interest
rates soared to more than 140 percent on credit card accounts during the first quarter this
year. The number of debtors’ associations nationwide is now estimated at 100.

Threatened with a debt moratorium, bankers and government officials were adamant that
loan restructuring on a case-by-case basis was the only acceptable alternative. Says Elizabeth
Barrera, banking analyst with Interacciones Casa de Bolsa: “If you get borrowers to agree to
that, you weaken the promoratorium movement. But if you can’t, you could get to a very dan-
gerous situation.”
12. Although loan restructurings are an important component of resolution of the current Mexican banking crisis, there remain many difficulties in the process. See, C. Torres, “Out of the loop, Mexican Restructuring of Firms' Debt Often Hurts Foreign Holders” W.S.J., May 13, 1996 at p. A-1.” “Because Mexico’s creaky legal system is ill-equipped to handle complex bankruptcy cases, many decisions are made by a clubby group of Mexican bankers and businessmen. Left out of the loop - and in some cases, out of the money - are the foreign bondholders who bought more than $20 billion of high-yield Mexican corporate debt in the early 1990’s. “There was a lot of greed and blind trust in a system that was fundamentally different’ from that in the U.S.,” says Mitchell Sahn, a partner at Latin Tactical Trading Group Ltd., a New York investment firm. “Investors have clearly had a wake-up call.”

A Different Debt Crisis  Mexico’s current debt crisis, stemming from its 1994 peso devaluation and subsequent recession, contrasts sharply with the one in the early 1980’s. Then, most foreign debt owned by the Mexican government and corporations was in the form of loans from a manageable number of international banks. By presenting a united front, they extracted favorable restructuring terms. But now, most Mexican borrowings are inbonds, and the foreignholders are a diverse and fractious lot, ranging from pension plans and mutual funds to wealthy individuals scattered around the world. Nearly all were caught flat-footed by the recession, and few are sufficiently organized to form bondholder groups and negotiate with the Mexican companies. The Mexican government itself has managed to stay current on its roughly $90 billion bailout arranged early last year by the U.S. government and the International Monetary Fund.

Corporate Problems Corporations are another story. Mexico’s slow recovery from the recession has left many of them strapped for cash, and international markets are in most cases loath to refinance their maturing debts. Investment bankers estimate at least a dozen companies with some $3 billion in foreign bonds outstanding have already started restructuring their debts or will do so later this year. Corporate blowups, though painful, are typically viewed by bondholders as a cost of doing business with high-risk, high-yield issuers. But what happens in the aftermath here is causing serious concern. Debt negotiations are always a rough business in which secured creditors - those with the strongest guarantees - win the choice cuts of a company's value; unsecured creditors get the scraps. But in the U.S. bankruptcy procedures are well-defined, and even out-of-court settlements follow an orderly process. No so in Mexico.”An out-of-court restructuring in the U.S. usually incorporates the concerns of all creditors,” says Agustin Berdeja, managing partner of Berdeja & Associados, a law firm here. “The lack of a specific legal framework for out-of-court restructures in Mexico sometimes results in some creditors being treated more advantageously than others.” As a substitute for law, the Mexican government has approved an unusual new office in Mexico City to negotiate out-of-court debt settlements. In charge is Eduardo Robinson Bours, a young poultry baron who helped negotiate some of the North American Free Trade Agreement’s agricultural accords for Mexico. He has become, in essence, Mexico's one-man bankruptcy system. He says he was chosen because his government, banking and business contracts allow him to 'knock on all three doors' with ease. Mr. Bours says he has no governmental authority. But sitting near his desk is a big red phone, a hot line linking him with government ministers and President Ernest Zedillo. Mr. Bours’s office is just a few steps away from the National Banking Commission, the bank regulatory agency. His expenses are paid by the government's bank-bailout fund.

Shaky Banks Some investors suspect that Mr. Bours’s real job is to keep Mexico’s banking system afloat. The banks were so badly damaged by the December 1994 devaluation that last year they had to ask their shareholders for more than $1 billion in new cash. Now, the weakened banks can’t afford to have their clients, the debt-swamped corporations, fall.” See also, D. Darrow, et. al., “Restructuring Strategies for Mexican Eurobond Debt,” 16 NW.J. INT’L. L. & BUS. 117 (1995).
II. Immediate Legal and Economic Context.

The apparent roots of the United States' capital adequacy crisis were found in the late 1970's. This period was characterized by the following factors:

1. high inflation in all goods and services;
2. an abrupt increase in interest rates, with prime exceeding 20 percent;
3. an oil crisis that made marginal production profitable;
4. resultant heavy investment in real estate and energy as inflation hedges; and
5. severe problems experienced by financial institutions, particularly thrifts, arising from:
   a. Significant undercapitalization and overleverage. While the early 1970's had been a period of growth, the U.S. Federal Home Loan Bank Board (“FHLBB”), during these relatively “good times,” consistently reduced capital requirements, rather than holding the line in requiring a relatively high ratio of capital to liabilities. This retreat was made during a time when the thrifts had sufficient earnings to develop an adequate capital base;
   b. Limitations imposed by law with respect to the rates banks and thrifts could pay for small deposits. Unregulated financial institutions were not so limited. Disintermediation was the logical result, as small depositors sought to minimize the ravages of high inflation by taking advantage of the rates offered by money market funds and cash management accounts;
   c. Banks and thrifts being forced to replace the small depositors with large certificates of deposit at competitive rates. This had a particularly devastating effect on thrifts whose assets consisted primarily of lower fixed-rate residential mortgages. The resulting negative spread caused thrifts to lose capital at an alarming rate.

These factors led to a series of reactionary events in the early 1980's, which resulted in a “finance/tax push” on real estate values. First, Congress passed the Depositary Institutions Deregulation & Monetary Control Act of 1980 (“DIDIMCA”), under which three major actions were taken. First, Federal Deposit Insurance Corporation (“FDIC”) and Federal Savings and Loan Insurance Corporation (“FSLIC”) deposit insurance was increased to $100,000 from $40,000. Next, the liability side of the balance sheet for banks and savings and loans was deregulated. Banks and savings associations could now

13. Pub. L. No. 96-221, 94 Stat. 132 (1980). § 202 indicates that DIDIMCA was promulgated as an attempt at an orderly phase-out and, ultimately, an elimination of limitations on the maximum rates of interest and dividends which could be paid on deposits and accounts by depository institutions. Congress determined that all depositors were entitled to receive a market rate of return on their savings as soon as it was economically feasible for depository institutions to pay such a rate. 12 U.S.C. §3501 (1996).
pay competitive rates for deposits without restriction. Finally, federal laws were adopted, pursuant to which state usury laws were preempted, to provide for unlimited interest rates on first lien loans on residential property (houses, condominiums, apartments, townhouses) and interest rates (on business and agricultural loans of $25,000 or more) that could equal five percent above the discount rate at the Fed window. (At this time, rates were still at an historical high and the Fed discount rate exceeded 14 to 15 percent.) These provisions allowed deposits to be brokered in fully insured $100,000 increments, with rates on deposits at whatever level was needed to attract the deposit and investment of deposits at rates exceeding state usury laws. DIDIMCA superficially may have alleviated the disintermediation problem, but it did not stop the huge losses of the thrifts which were still carrying lower fixed-rate assets.

Meanwhile, inflation in real estate prices continued, even as the general inflation rate abated. Real property inflation was fueled by the tax shelter business, which received a large push from the Economic Recovery Tax Act of 1981 ("ERTA"). ERTA improved tax shelter opportunities in real estate principally by reducing the depreciable life of improvements to 15 years from 35 years. In addition to this new incentive, investors already could deduct investment interest paid or accrued, and could take advantage of non recourse mortgage financing for purposes of deducting losses. If the property were held for longer than one year, it was entitled to the 60 percent long-term capital gains exclusion, thus insuring a maximum tax of 20 percent on disposition (in 1984, the holding period was shortened to six months). Before long, limited partnerships or syndica-

15. Id. at § 204. Authority to control the rates paid on deposits by depository institutions under Pub. L. No. 89-597, 80 Stat. 823 (1966) was provided for a term of six years from the date of enactment of the legislation in order to give thrift institutions time to incorporate the new powers granted to them so that they might increase their earnings and be in a position to attract deposits by paying market interest rates. The Federal Reserve Board, the FDIC and the FHLBB, however, were permitted to regulate depository institutions' advertising of interest rates. 12 U.S.C. §1735f-7a (1996).

16. DIDIMCA § 501. States were permitted to override the federal preemption of state usury limits on home mortgage loans within the period after April 1, 1980, and prior to April 1, 1983. The override could consist of the adoption of a law or a vote by voters in favor of any provision, constitutional or otherwise, which stated explicitly that the state did not want the federal preemption to apply to loans made in that state.

17. DIDIMCA § 511.

18. Id. at § 308(a)(1)(A).

19. Id. at § 204.

20. Id. at §§ 501, 511.

21. Pub L. No. 97-34, 95 Stat. 172 (1981). § 212 of ERTA amended §§ 46 and 48 of the I.R.C. and increased the investment tax credit for rehabilitation expenditures to 15 percent for nonresidential 30-year old buildings, 20 percent for nonresidential 40-year old buildings; 25 percent credit for residential and nonresidential certified historic structures; and repealed the accelerated cost recovery and demolition disincentives for certified historic structures.

22. ERTA § 201; I.R.C. § 168 (the recovery period was subsequently extended to 18 years by the Deficit Reduction Act of 1984 and then to 19 years in 1985). The taxpayer was given the option to elect to use the straight-line depreciation method over 15 years, 35 years or 45 years for 15-year public utility property.


tions became an attractive way to invest in real estate because they generated tax savings and profits that passed through to investors. Broader participation in the apparently highly profitable real estate business was seen as a panacea for the thrifts.

Congress passed the Garn-St. Germain Depository Institutions Act of 1982 ("Garn-St. Germain"). Garn-St. Germain allowed thrifts to expand their lending powers by allowing commercial and nonresidential real estate lending (so-called acquisition, development and construction loans, as well as commercial loans), make direct investments in real estate (state-chartered institutions in some jurisdictions already enjoyed broad investment authority), participate in ownership of real estate through joint ventures, partnerships and similar vehicles, eliminate loan-to-value ratios for residential mortgages and, in some instances, utilize loan-to-value ratios up to 100 percent. The result was that a savings and loan charter was more flexible than a bank charter.

Entrepreneurs were encouraged to acquire savings and loans and operate them as giant real estate companies. State laws were amended, giving state savings and loans expanded powers. California, Florida and Texas were examples. California allowed 100 percent of an in-state thrift's assets to be contributed to a subsidiary service corporation for investment activities. Texas allowed leverage of 20-to-1 on capital in service corporations. Capital requirements of savings associations were dropped to three percent of liabilities on a long-term averaging basis, as opposed to five percent. Banks' capital requirements remained at five and one-half percent primary and six percent secondary. Leverage in the savings and loan industry was 33 times capital raised, and in the banking industry, 15 times capital raised.

Regulatory and examination forces of state and federal regulatory bodies were not expanded to handle effectively the regulation of the broadened powers arising from DIDIMCA and Garn-St. Germain. In addition to new powers, there was a quantifiable risk increase as the amount of deposit insurance rose two and one-half times from $40,000 per account to $100,000. Incredibly, the FDIC system had ten times more personnel than the FSLIC system. In the midst of all this change, the Federal Home Loan Bank ("FHLB") of Little Rock, Arkansas, was moved to Dallas, Texas, causing significant loss of experienced personnel. Then several events occurred:

26. Pub. L. No. 97-320, 96 Stat. 1469 (1982). Federal savings associations were granted expanded lending and investment authority by this Act, as an attempt to provide them with the flexibility necessary to maintain their role of providing credit for housing.
32. Id.
34. Texas Savings and Loan Department, 10 Tex. Reg. 3429 (1985) (codified at 7 Tex. Admin. Code 64.7(b)).
• oil and gas prices dropped;
• Empire Savings of Texas failed;
• Continental Illinois Bank failed;
• Penn Square Bank of Oklahoma failed;
• certain instances of fraud, deceit and abuse appeared; and
• reactive re-regulation commenced.

These events precipitated the crisis which emerged first in the thrift industry and in Texas banking and spread throughout the capital base of the nation's businesses and financial institutions. Reregulation of the financial institutions and elimination of tax incentives for real estate removed the finance/tax push on real estate values and caused values to shrink and capital to "evaporate" from our financial system. The crisis began slowly, but quickly gathered momentum.

Beginning in 1984 and 1985, reregulation of the thrifts commenced in earnest. Personnel in the FHLB of Dallas were shaken up, with tough regulators appointed to key positions. New appraisal standards were adopted, resulting in lower values and lower comparables, and often were applied on a retroactive basis. New capital regulations were adopted requiring more capital, when the aim should have been to preserve existing capital. New growth restriction regulations were adopted, and classification of asset regulations were also adopted.

All of these measures treated the emerging thrift crisis as one that could be cured simply by tightening the rules. However, these measures failed to take into account their effect on the dynamics of the real estate industry and its interrelation with the value of assets held by thrifts and banks. The upshot of the sudden change in the rules was that property values depreciated quickly and insidiously in a downward spiral. The FHLBB's overreaction led to:

35. These standards are currently located at C.F.R. § 563.17-1a(c)(1). The Code sets forth three appraisal standards that, at a minimum, must be included in the appraisal policies of every insured institution and service corporation. First, the appraisal must be based upon the definition of market value as set forth in the regulation. This definition contemplates the consummation of a sale as of a specified date and the passing of title from buyer to seller under open and competitive market conditions requisite to a fair sale. Second, the appraisal must be presented in a narrative format. The appraisal report must be sufficiently descriptive to enable a reviewer to readily ascertain the estimated value reported and the rationale for that estimate. The analysis is required to be as detailed and in depth as the complexity of the real estate requires. Third, an appraisal must contain a sales history of the real estate appraised. Generally, sales within the three previous years must be disclosed.


37. 12 C.F.R. § 563.98 (1990). This section established new restrictions for equity risk investments by savings associations. The limits for investments were based on tangible capital in relation to total liabilities. In addition, permissible investments were described and diversification was required.

1. a precipitous decline in available financing by thrifts;
2. revised appraisal standards and nervous appraisers causing lower appraised values that, by way of comparables, caused still further lowering of values;
3. existing capital evaporating from this loss of real property value;
4. incipient negative leverage; and
5. the loan portfolios of many of the financial institutions began to consist primarily of term loans which were due to be paid in full at maturity.

New tax legislation then took tax incentives out of property ownership, causing further loss of real property value and hence financial institution capital. The Tax Reform Act of 1986 ("TRA-86") virtually eliminated tax as a consideration in the purchase of real estate. The easy write-offs that once made otherwise marginal real estate development profitable were gone.

Nineteen eighty-six was the last year that developers could take advantage of the faster depreciation allowed under the old law. Under TRA-86, the depreciable life for real estate improvements went from 19 years to 31 years. The "at risk" rules changed, limiting tax write-offs to the amount actually invested. The deductibility of interest used to finance investment property was limited to the amount of net investment income.

Moreover, new "passive loss" rules required that losses from an activity in which an individual did not materially participate could be deducted only from income derived from a passive activity. Prior to these rules, an investor could deduct these losses from any income, including salary.

39. For each dollar of capital loss, thrifts were required to shrink assets $33 1/3, and banks $15. Shrinkage was difficult, however, since the depreciating values meant that there were no buyers or new financing available. When shrinkage did occur, it usually was from the sale of earning assets, and the loss of income from those earning assets' further reduced capital, requiring still more asset shrinkage. The consequence of this downward spiral is obvious.

40. Needless to say, the majority of these loans were not paid at maturity. As a result, the institutions were deprived of a major source of asset shrinkage.

41. Pub. L. No. 99-514, 100 Stat. 2085 (1986) (hereinafter "TRA"). The 60 percent deduction for long-term capital gains were repealed; residential real estate was to be depreciated over 27 1/2 years under the straight-line method, nonresidential real estate was to be depreciated over 31 1/2 years under the straight-line method; the investment tax credit was repealed; the Rehabilitation tax credit was substantially reduced; "at risk" rules now applied to real estate; and losses from "passive activities" could be offset income from other passive activities.

42. TRA 1986 § 201. This section amended I.R.C. § 168.

43. TRA 1986 § 503. This section repealed I.R.C. § 465(c)(3)(D), which excluded the holding of real property from the application of the "at risk" rules.

44. TRA 1986 § 511. This section amended I.R.C. § 163(d), such that after the Act was passed, investment interest expense was only to be deducted against net investment income.

45. I.R.C. § 469.

46. I.R.C. § 165.
The capital gains tax exclusion was repealed, resulting in a maximum tax rate of 28 percent instead of 20 percent. Finally, the investment tax credit was eliminated and the rehabilitation credit substantially reduced.

As a result of the initial finance/tax push in real estate values and the subsequent removal of that finance/tax push, a spiraling depression in values occurred with losses in value as high at 50 percent, rivaling the October 1987 stock market debacle. There was not a shift of wealth; there was a loss of wealth. Operating losses become monumental. For banks and thrifts, these were caused by:

1. loss of operating income:
   a. no new loans being made since no growth is allowed (i.e., there is no capital to support any growth; to the contrary, shrinkage is required);
   b. borrowers not paying interest, much less principal; and
   c. income not being realized from collateral by reason of legal issues and lender liability considerations;

2. increase in operating expenses:
   a. increase in cost of funds, despite FDIC insurance (the so-called Texas premium);
   b. legal fees running up to $500,000 per month at many thrifts;
   c. consultant fees equal to that same amount being incurred per month;
   d. property operating and management costs increasing with respect to OREO in non-performing assets; and
   e. hidden costs arising from constant regulator involvement, required independent reappraisals and additional accounting and personnel expense;

3. delays in dealing with nonperforming loans caused by:
   a. borrowers' lender liability lawsuits (sometimes successful), often brought to buy time to deal with the adverse tax consequences of foreclosure;
   b. injunctions and restraining orders limiting enforcement of creditors' rights against security;
   c. regulatory delays—most thrifts and many banks were under some type of regulatory control or scrutiny; and
   d. inter-creditor disagreements on participated loans.

The rush to real estate investment, inspired by previously favorable tax legislation and fueled by the massive availability of capital for real estate investment provided by banks and thrifts, created an enormous constituency of owners who, in the face of the loss of tax benefits due to changes in the tax laws, were confronted with significant adverse tax conse-

47. TRA 1986 § 301. This section amended I.R.C. § 1202.
48. Id. at § 302(a)(1).
49. Id. at § 211.
50. Id. at § 251. The rehabilitation tax credit for certified historic structures was reduced from 25 percent to 20 percent, a credit of 10 percent was provided for substantial rehabilitation of buildings placed in service before 1936, there was to be no credit for any buildings placed in service after 1935, that was not certified historic, and the credit was subject to the limitations on passive losses and credits.
quences on asset disposition. The problem of adverse tax consequences was exacerbated by collapsing values and the resulting lack of resources from asset sale proceeds to pay the tax bill. Owners generally could not sell for a price which would pay the tax bill for the phantom gains from the disposition of property upon which the outstanding debt is in excess of the owner's adjusted basis in the property, as reduced by depreciation deductions, much less provide for recovery of equity or the making of a profit. Just as importantly, the debtors who owned the real estate could not permit foreclosure on the collateral by the creditors since that would trigger the same tax problems for the debtor as a sale to a third party. Financial institutions, which were under pressure to shrink, sought to enforce foreclosure against the collateral, but generally paid no attention to the underlying systemic tax and value problems which faced the debtor. This often resulted in costly and time consuming litigation and bankruptcies initiated as protective action by debtors and designed, in most cases, to delay and afford to the debtor some opportunity to shift the unrecognized losses already in the system, including both tax losses and real losses of equity, to others.

In the late 1980's, in continuation of the quest for higher returns and fee income and, based in part on the commercial acceptability of borrowing on the basis of expected cash flow and anticipated asset dispositions as well as the introduction and market acceptance of noninvestment grade corporate high yield debt, as an alternative to real estate financing and equity investments, investors began to concentrate heavily in these highly leveraged transactions ("HLTs"), such as leveraged buyouts. These HLTs afforded significant tax incentives by allowing interest on corporate debt to be deducted, as distinguished from nondeductible dividends on equity. The rise in HLTs corresponded to the general tendency of American businesses to leverage themselves to unprecedented levels. Debt service required ever larger portions of debtor companies' cash flow. The decline of business revenues due to regional economic woes and increases in interest rates eroded the liquidity margin between success and default. Debtor companies with substantial amounts of floating rate debt, zero coupon debt or short or medium-term debt that must be refinanced, found that there was no practical alternative to a reorganization when faced with the reduced flexibility of federally-insured financial institutions which could no longer freely refinance these HLTs and when faced with a contracting market where the debtor could not readily spinoff assets at acceptable prices. The real question in any reorganization became how the cost of that deleveraging and loss recognition would be shared and how it would be effected.51

While the scenario described above was suffered primarily by thrifts and banks in Texas, New England and the Mid-Atlantic states, it inevitably spread in varying degrees to financial institutions in other regions. On December 19, 1989, the Office of the Comptroller of the Currency ("OCC") issued a Fact Sheet,52 in which it clearly set out its

51. See Cieri, An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts, 45 Bus. Law 333 (Nov. 1989) with respect to restructuring of HLTs.
52. Under the heading "Current and Future Actions," the Fact Sheet states that the OCC is using its experts in real estate lending problems to assist in reviewing targeted banks. The Fact Sheet states that the purpose of this review is to help assess banks' vulnerability to softening real estate markets and review real estate loan portfolios in banks with potential problems. The Real Estate Valuation Model was to be used to identify those banks with potential problems or weaknesses in targeted markets. The OCC stated that this model would be refined to fit the characteristics of individual markets.
intention to identify those banks which may be vulnerable to softening real estate markets and to review those banks with potential problems. Those banks most likely to be subject to an OCC target exam were those that had a large real estate loan portfolio, or were in a market that the OCC macroeconomic model indicated as approaching an overbuilt condition. The Fact Sheet stated that "[i]f banks are not recognizing problem real estate loans, examiners will ensure that they do so in the future."53

The intermediate term effect on these institutions was unpleasant, at best. Federal banking regulations required that OREO be marked to market no less frequently than annually.54 Actual practice of the OCC in a pervasively declining regional market was been to require that banks anticipate future value declines by establishing "OREO valuation reserves," also a direct charge to capital, unlike the "loan loss reserve." As the real estate market in a region dried up, comparable sales become so infrequent that they were deemed meaningless by bank regulators. The Texas and New England experience showed that the value of a bank's OREO portfolio was then determined by the judgment of regulators, using discounted cash flow computer models and the regulators' assumptions, even when those regulators were based in other parts of the nation and likely had no personal knowledge of the regional market. This discounted cash technique was also used to value land, an appraisal method not sanctioned by any professional appraisal body. The effect of OREO write-downs and valuation reserves on banks' earnings and capital was devastating. These same write-down and valuation practices were applied to other assets, including HLTs. The impact of these events on the marketplace included general credit tightening and restrictive requirements for additional collateral and equity support for businesses generally.

All of these developments received high profile attention as they affected U.S. financial institutions. The deterioration of capital and the intransigence of U.S. financial institutions in their battle for survival placed a premium on the peaceful and nondestructive allocation of loss and the preservation of the base of businesses in the most efficient manner possible. The goal of a debtor's nonjudicial workout is to provide for such an efficient and equitable loss allocation with respect to that debtor, short of bankruptcy, and to preserve its business as a valuable going concern.

III. Impact on Debtors.

In a collapsing economy, debtor companies tend to recognize and attack problem assets or financing on an individual basis. This tendency is exacerbated when one or more of the debtor's creditors, caught in the downward spiral of the systemic capital adequacy crisis, behaves in a reactionary mode and focuses only on its own problems with the debtor, disregarding the debtor's other credit relationships and problems. At some point, the debtor may come to realize that it is unable to maintain many separate negotiations for the resolution of its problems simultaneously on a coherent basis. The debtor will recognize that many of its problems are interrelated and that some of its lenders or investors are more aggressive in seeking collection and pursuing default remedies than others. The debtor will have been prone to resolve its problems with its most troublesome creditors on a preferential basis and to defer the resolution of problems or potential problems with its more patient creditors, to their mutual detriment.

53. The Fact Sheet also stated that the OCC would require the targeted banks to take whatever corrective action was necessary with respect to real estate lending practices and loan portfolios.

Each creditor considers its loan transaction and prospects for collection from a narrowed perspective. As the debtor's financial condition deteriorates, each creditor seeks to spread its grip over the debtor's resources to maximize its prospects for collection. When the debtor seeks to respond to each creditor on an individual basis, and where each creditor adopts its hegemony over the debtor's financial resources through cross-collateralization, requirements of completion deposits, establishment of performance hurdles or deadlines which limit flexibility and distort decision making, the debtor may find that, in the process, its financial resources are insufficient to meet the demands of all its creditors.

The formulation of an overall workout plan for a debtor in the environment of a systemic capital adequacy crisis and the responses generated by its financial institution creditors, requires a change of focus or frame of reference by the debtor, as well as its creditors. Unless the debtor's efforts are coordinated properly and the work handled efficiently, the debtor's efforts will become paralyzed and the expense undertaken in the preparation of a consensual workout plan will be wasted. No overall workout plan can be accomplished without successful individual workouts, through renegotiation of the affected loan or credit transactions. Conversely, the only way in which the debtor can achieve a successful workout is by placing these individual successful workout renegotiations in the context of an overall plan, which is designed to maximize return to all of the creditors on a fair and equitable basis and to motivate the debtor to follow through with the plan and ultimately avoid judicial reorganization or liquidation. The plan must accommodate the financial and legal positions inherent in each individual workout negotiation situation, and each individual negotiation situation must be placed in the context of the overall workout plan.

In its initial stages, the plan is a reflection of a coherent communication of the debtor's legal and financial condition. The effect of this broad-based communication to the creditors of the debtor will have the effect of repositioning many of the debtor/creditor relationships from their status prior to presentation of the plan. This process of repositioning generally will go through several stages in which the overall nature of the plan may shift based upon shifting individual workout negotiations and individual negotiations will vary in light of the economic implication of the plan upon the specific transaction and based upon the legal implications of the relationship and of the plan itself. The objective of a consensual reorganization is to obtain the essential benefits of protection afforded under the federal bankruptcy laws without the attendant costs, stigma, and potential loss of control. The basic equitable principles underlying a successful consensual reorganization are the same basic equitable principles that underlie the completion of a successful reorganization under Chapter 11 of the U.S. Bankruptcy Code. A consensual reorganization, however, is not the legal equivalent of a proceeding under the Bankruptcy Code. Any discussion of reorganization under the Bankruptcy Code is beyond the scope of this paper.

IV. Consensual Workouts.

A. ADVANTAGES OF CONSENSUAL WORKOUTS FOR BOTH DEBTORS AND CREDITORS.

Consensual workouts fix the rights of the parties and avoid the uncertainties of litigation in bankruptcy. Other advantages afforded by consensual workouts, as opposed to bankruptcy, include the following:

1. Consensual workouts are more flexible; workouts permit legitimate agreements to accomplish the consensual intent of the parties, limited primarily by depth and breadth of imagination;
2. Consensual workouts preserve higher asset values; debtors are given incentives to maximize recoveries to limit deficiency liability;
3. Consensual workouts are generally less expensive, both from an administrative perspective and from a legal perspective. Workouts limit costs and avoid burdens of litigation and bankruptcy;
4. Consensual workouts often afford more benefits to creditors and debtors, both tangible and intangible:
   a. management retains control of business;
   b. debtor avoids "stigma" of bankruptcy;
   c. debtor's principals may avoid or defer liability on personal guaranties;
   d. creditor might obtain acknowledgment of outstanding indebtedness and of validity of liens and encumbrances;
   e. creditor might obtain waiver of defenses, setoffs and counterclaims;
   f. creditor might obtain additional collateral and guaranties; and
   g. creditor might correct deficiencies in loan or security documents.

B. DISADVANTAGES OF CONSENSUAL WORKOUTS FROM THE DEBTOR'S STANDPOINT.

Since a workout is a consensual arrangement, neither debtor nor cooperating creditors can bind nonassenting creditors nor halt litigation or foreclosure proceedings by uncooperative creditors. Substantial unanimity is required of all creditors. This unanimity is often difficult to obtain.

Claims by governmental entities are frequently more difficult to deal with in workouts because governmental or government-controlled creditors tend to be less flexible; their respective regulatory guidelines frequently do not permit flexibility.

Additional problems include:

1. The debtor is unable to reject burdensome leases or other executory contracts;
2. The debtor is unable to recover property in possession of foreclosing creditors or to defeat prior attachment, garnishment or levy;
3. The debtor is unable to recover preferential, fraudulent or voidable transfers that otherwise might be avoidable in bankruptcy; and
4. The debtor has no convenient forum (such as an experienced bankruptcy court) for expeditious resolution of disputes, enforcement of sales free and clear of liens and encumbrances, determination of priority of liens and the like.
C. DISADVANTAGES OF CONSENSUAL WORKOUTS FROM THE CREDITOR'S STANDPOINT.

Unlike bankruptcy, consensual workouts do not subject actions of the debtor and its principals to judicial scrutiny and control. Participation in a consensual workout might perpetuate ineffectual or dishonest management. It may also permit continued erosion of collateral or other asset values if control of timing and price of liquidation remains with the debtor. Participation in a consensual workout does not prevent a subsequent bankruptcy filing if the workout fails.

D. CONDITIONS FOR A SUCCESSFUL CONSENSUAL WORKOUT.

Participation in a consensual workout makes no sense if the crucial components of a successful workout are not present. Those elements depend upon the attributes of the particular workout. For example, inability to survive in the long term is inconsequential if the workout contemplates an orderly liquidation of assets, as opposed to continuing business operations. Many consensual workouts initially envision long-term survival, but as negotiations progress, they evolve into more or less of an orderly liquidation. In evaluating a proposed consensual workout, some of the most important factors relating to its potential success include:

1. adequate liquidity (cash) available to fund the workout;
2. readjusted and realistic expectations by all parties;
3. adequate disclosure of information; a consensual workout is, in a sense, a private bankruptcy proceeding, where the scope of information provided by debtor should be substantially equivalent to that disclosed in a formal bankruptcy filing;
4. flexibility of the legal rights and practical leverage of each of the participants;
5. appreciation of the legal rights and practical leverage of each of the participants;
6. absence of significant avoidable transfers which prefer one creditor over others in the same class, as well as equal treatment of classes of creditors;
7. perceived fairness in the treatment of differing creditor and equity classes;
8. continuing cooperation of critical creditors, employees and management personnel;
9. confidence in management;
10. confidence in the debtor’s business plan; and
11. ability to operate profitably within the applicable regulatory climate.

E. PITFALLS WHICH CREDITORS SHOULD SEEK TO AVOID IN A CONSENSUAL WORKOUT.

Assuming that the key elements for a successful consensual workout are present, creditors should guard against:

1. inducing others to extend credit to the debtor;
2. paying debtor’s employees without making adequate provisions for trust fund taxes or funding the payroll with knowledge that debtor’s management will not surrender or withhold appropriate taxes;
3. failing to comply with bulk transfer provisions;
4. failing to take immediate possession of surrendered collateral;
5. becoming enmeshed in unintended admissions, waivers or releases during negotiations; and
6. exercising control over the debtor.

V. Evolution of Insolvency Law as a Context for Consensual Workouts.

Awareness of the evolution of insolvency law brings context to current national, as well as international, problems of insolvency. Historically, the United States has addressed the problem of insolvency through its bankruptcy laws. The Bankruptcy Act of 1800 was the first bankruptcy law adopted by the United States Congress. The Bankruptcy Act of 1800 closely followed the English Statute of Bankrupts. In turn, the origins of the English Statute of Bankrupts may be traced back to the laws of other European countries, the Italian city-states of the 14th Century, and even further to the Roman Empire.

The various practices employed in dealing with the problem of a debtor who either refused, or was unable, to pay its debts date back as far as the extension of credit itself. In the primitive and ancient cultures, public opinion provided two sanctions by which a debtor could be compelled to perform his part of a contract. Each of these sanctions was extremely powerful. One sanction was religious, while the other was more primitive and severe: Execution.

57. Id.
58. Id. at 17. On ancient Roman collection practices, "If the debtor be insolvent to serve creditors, let his body be cut in pieces on the third market day. It may be cut into more or fewer pieces with impunity, or, if his creditors consent to it, let him be sold to foreigners beyond the Tiber." Twelve Tables, Table III, 6 (c. 450 B.C.).
59. Levinthal, The Early History of Bankruptcy Law, 66 U. Pa. L. Rev. 223, 229 (1918). For instance, in India of old, and currently in Nepal, creditors engaged in the practice of "sitting d'harna" and, in ancient Ireland, creditors engaged in "fasting on" debtors. These practices involved the creditor placing himself before the debtor's doorway and remaining until the debt was paid. This practice was extremely effective, in light of the fact that debtor would have been instantly and severely punished by public opinion if he were to permit his creditor to suffer from exhaustion or die of starvation at his door. Id. at 229, citing Tarde, "Evolution of Procedure," in Primitive and Ancient Legal Institutions 700 (A. Kocourek & J. Wigmore eds. 1915). The Hindus employed a system of self help. In this system, the creditor could take his debtor and force him to perform labor for him or he could resort to violence and kill or maim the debtor, confine his wife, his sons or his cattle. Lang, "Origin of Exogamy and Totemism," in Primitive and Ancient Legal Institutions 230 (A. Kocourek & J. Wigmore eds. 1915), citing Manu. XIII, 48 ff. The Egyptians, however, only provided for the attachment of the debtor's property, not his person. The rationale for this was that the state might at any time require the debtor's service, in peace as an official or laborer, and in war as a soldier. Id., at 230-31, on the authority of Diodorous, I, 79; Reveillout, Cours de Droit Egyptian, at 42. In time, legal process against insolvents evolved to the point where execution was had against the property of the debtor, rather than against the debtor himself. Undoubtedly, this was the result of a change in objective from retaliation to compensation. Tarde, at 232. In ancient systems of law, whether the debtor was actually honest or dishonest, insolvency was seen as something that was irregular and fraudulent. However, in time the unfortunate insolvent was distinguished from the fraudulent bankrupt. See, e.g., Code of Hammurabi, §§ 116, 117, where protection from creditors was provided to the debtor who was made insolvent by misfortune.
In 13th Century England, the common law provided for imprisonment of the debtor until he "made agreement (with his creditors) or his friends for him." Imprisonment was intended to compel payment of the debt and not to punish the debtor for his failure to pay.

The most important early English bankruptcy law was the Statute of Bankrupts. The Statute of Bankrupts was directed toward punishment of fraudulent debtors and only applied to debtors who were merchants, providing that a debtor who committed "an act of bankruptcy" was to be reputed, deemed and taken for a bankrupt. Upon complaint, the Lord Chancellor could appoint a commission of "wise, honest and discrete" persons who were authorized to seize the property of the bankrupt and sell it for the payment, pro rata, of the debts of the bankrupt. The bankrupt, however, remained liable to the extent that his creditors were not paid in full. The commissioners had the power to imprison the bankrupt and, by virtue of a later statute, could be subject to pillory and the loss of an ear as well. The design of early English bankruptcy law was to protect creditors and to punish debtors who were trying to avoid payment of just debt.

In the early 18th Century, the harshness with which bankrupts were treated was greatly reduced by statutes which provided for the granting of a discharge to the bankrupt of the debts owing at the time of bankruptcy. This development was attributed to the notion that bankrupts were not always fraudulent, and sometimes failed because of circumstances beyond their control; such bankrupts were entitled to relief. Society recognized that unlimited incarceration of the debtor did not usually lead to reimbursing his creditors. In addition, creditors came to believe that a law which was "all penalty and no reward" was self-defeating; forcing bankrupts to relinquish all of their property to satisfy some creditors and then exposing them to unlimited imprisonment by others encouraged evasion, even by merchants who otherwise would have been willing to cooperate. Finally, creditors acknowledged that mercantile credit was given in the interest of the creditor, as well as of the debtor, and that the giving of credit necessarily involved some risk and, therefore, it followed that the business of the merchant should insure against this risk by adding on a percentage for the credit which he advanced and that all a debtor ought to pledge to this credit was his estate, and not his future earnings or personal liberty. Not until well into the 19th Century did the notion of allowing a debtor to declare bankruptcy voluntarily become a part of English bankruptcy law as a means of finding relief from creditors.

61. Id. While some may argue that imprisoning the debtor was punitive in nature, the debtor could always terminate his imprisonment by paying the debt.
62. 13 Elizabeth, c.7 (1571).
64. "Acts of bankruptcy" include[d] the debtor's departure from the realm, his taking refuge in his home, his taking sanctuary and various other acts if his purpose was to avoid process with the intent of defrauding or hindering his creditors.
67. 4 Anne c. 17 (1705); 10 Anne c. 15 (1711). These statutes applied only to merchants, however.
69. Boshkoff, supra. note 66, at 69.
70. Levinthal, supra. note 65, at 18-19.
71. Cohen, supra. note 60, at 5-6.
Insolvent debtors historically have received different treatment, dependent upon whether they were merchants. A merchant was entitled to bankruptcy in which, upon surrender of his available assets, he was discharged from liability to his creditors. Insolvency also applied to nonmerchants, who however, after released, remained obligated to pay the remainder of their debt. Blackstone probably best expressed the rationale for restricting bankruptcy to the merchants when he stated:

"But [the laws] are cautious of encouraging prodigality and extravagance by this indulgence to debtors; and therefore they allow the benefit of laws of bankruptcy to none but actual traders; since that set of men are, generally speaking, the only persons liable for accidental losses, and to an inability of paying their debts without any fault of their own. If persons in other situations of life run in debt without the power of payment, they must take the consequences of their own indiscretion, even though they meet with sudden accidents that may reduce their fortunes: the law holds it to be an unjustifiable practice, for any person but a trader to encumber himself with debts of any considerable value. If a gentlemen, or one in a liberal profession, at the time of contracting his debts, has a sufficient fund to pay them, delay of payment is a species of dishonesty, and a temporary injustice to his creditor; and if, at such time he has an insufficient fund, the dishonesty and injustice is the greater. He cannot, therefore, murmur, if he suffers the punishment which he has drawn upon himself. But in mercantile transactions, the case is far otherwise. Trade cannot be carried on without mutual credit on both sides: the contracting of debts is therefore here not only justifiable, but necessary. And if by accidental calamities, as by loss of a ship in a tempest, the failure of brother traders, or by the nonpayment of persons out of trade, a merchant or trader becomes incapable of discharging his own debts, it is his misfortune and not his fault."

In the United States, Congress was given the authority, under the Constitution, to enact laws concerning bankruptcy. Every bankruptcy law in the United States has been the product of some financial crisis or business depression. The bankruptcy legislation in the United States is a reflection of changes in economic conditions and viewpoints in this country. Bankruptcy law in the United States has evolved through periods of pro-debtor tendencies, pro-creditor tendencies and compromises between each. The United States generally has accepted the principle that bankruptcy is required in the public interest of the nation, apart from the effect of the law upon particular individuals upon whom the law was to operate. The interest of the nation lies in the continuation of business and the conservation of property for the benefit of creditors and the debtor, and not in the sale and distribution of the assets among the creditors, or even in the debtor's own immediate discharge from debt. The forced sale of property and the stoppage of business in times of financial crisis constitutes a loss to the nation at large, as well as to the individual debtors and creditors. Thus, bankruptcy law has developed into a system which attempts to achieve three objectives:

74. Id.
75. Id.
1. protect creditors from each other;
2. protect creditors from dishonest debtors; and
3. protect the honest debtor from his creditors by means of discharge.76

Those laws that seek to protect creditors from one another attempt to prevent any one creditor from obtaining more than its proportionate share of the debtor's assets. Such a law provides for the collective execution of process directed against all of the property of the debtor for the benefit of, and at the common expense of, all the creditors. When the debtor is unable to pay all of its debts in full, the principle of contribution is invoked, and any loss due to insolvency is thereby spread among all of the creditors. The bases for this execution process are both social and economic. In order to achieve these objectives, a method of managing the debtor's estate during the pendency of the process is required. Some entity must be given control over all of the property of the debtor to collect, manage and distribute all the assets. When this process is handled through bankruptcy law, the expense of the process and depletion of the debtor's estate to the detriment of the creditors is significant.77 The objective in a consensual workout is, through a voluntary and forthright action by the debtor, to inspire in the creditors a high level of trust and confidence in the debtor's adherence to the fundamental principles of bankruptcy law and the likelihood of achievement of their mutual objectives by voluntary and consensual management, and thereby to avoid the polarization and expense of a judicial achievement of those objectives and to thereby maximize repayment.

VI. Consensual Workout Theory.

Consensual workouts are based upon the fundamental assumption that the debtor has been honest and forthright in its operations and that current economic difficulties leading to workout or reorganization are due to honest mistakes of business judgment or market conditions not susceptible of anticipation or accommodation by the debtor. The systemic problem of deteriorating capital adequacy is precisely such a circumstance. Resolution of the resulting financial problems between a debtor and creditor then need not necessarily be a violently adversary process. A calm and dispassionate evaluation of the factors leading to the defined economic problem, however, should lead to a fairly clearly defined set of options under existing legal and financial structures for problem resolution. The mission of both the debtor and the creditor in a consensual workout is to go past artificial adversary posturing and to seek to understand the underlying root of the economic problem and allocate the loss occasioned by that problem in accordance with the legal and economic facts. If both the debtor and the creditor see the facts clearly, their interests should be aligned in resolving the allocation of loss in accordance with those facts and the law in the most expeditious and efficient manner possible. These parties are in the position to suffer the most pain in the absence of such a consensual agreement and are in the position to

76. Levinthal, supra, note 70, at 25. It should be noted that not all systems of bankruptcy law seek to achieve this third goal.
77. Warren, supra, note 73, at 112, citing AM. L. REV. VII (July 1873), "[F]rom the beginning to the end, there is one continuous, increasing plucking at the estate. Merchants have come to believe it best to settle with their debtors out of the bankrupt court. In its details, the law is perplexing, cumbersome, annoying, and expensive."
gain the greatest economic benefits from its success. A successful consensual workout requires, and is the product of, this alignment and agreement.

The organization of the legal and economic facts into a workout plan, however, involves a complex interrelated set of decisions which, in each case, must be measured against the available alternatives. The test in each case for each of the constituent decision makers, both the debtor and the creditor, and the constituents within the debtor organization, including partners, investors and employees, is to measure and prioritize the consequences of each decision under various alternatives. A consensual workout should produce an alignment of the constituents’ best legal, economic and personal interests. A correct alignment among the constituents in the face of the legal and economic facts will produce a will to action and to execution of the workout.

Performance incentives or inducements can be built in with respect to any or all of these constituents to further their will. Examples of such incentives or inducements include preferential treatment for risk-taking by creditors, incentive fees or participation in residuals and limitation or elimination of personal liability for debtors under certain circumstances. If will, action and performance by the debtor, combined with time and space afforded by a consensual workout plan, will not produce a greater repayment to creditors than a liquidation, the creditors will not permit any economic incentive or inducement to such will, action and performance. The objective of the consensual workout and the definition of its success is the effectuation of the lowest cost and most efficient allocation of loss on the most equitable basis, considering the facts and the law, which produces the maximum repayment to creditors. Every decision and the consideration of every alternative must be considered against this test of success.

Debtors should be cognizant that, in many cases, lenders do not act rationally. The motivation of loan officers and lender management is often inconsistent with their role in the workout process. Many decision-making motivations for these individuals are personal and relate to internal politics in or external pressures on their employer organizations or to regulatory pressures. Often, the responsible officers are not given any incentive to understand and do not understand their factual and legal position. The debtor must be mindful of the problems presented by these anomalous situations and of the effect of the state of mind of the various decision makers on their approach to the workout process.

Although it is the objective of a consensual reorganization to avoid adversary positioning, it may be necessary for the debtor or for the creditors to utilize adversary tools, such as bankruptcy proceedings, litigation and other aggressive and adversary actions, from time to time, to level the field of negotiations and protect consensual participants from creditors who seek to obtain an advantage without providing a corresponding benefit to the consensual workout process or to force reluctant or misguided participants to the bargaining table. This process is often required in one of two situations:

1. where responsibility for negotiations on behalf of a creditor must be moved out of the hands of a defensive loan officer, who may desire to avoid the issues and protect his personal position in the organization; or
2. where responsibility for negotiations on behalf of a debtor rests with an individual whose ego and self image dominate strategy.

In each of these situations responsibility and control must be delegated and moved into the hands of a professional problem solver. Creditors will often take a very tough
position from both a legal and a business point of view to flush out the level of commitment and will of a debtor who proposes a consensual workout or plan. The debtor must remain calm, stick with the workout plan and utilize appropriate adversary proceedings sparingly, but with sufficient definition and purpose, to protect its position and move the workout process forward, stopping short of polarizing positioning.

The plan formulation process must recognize creditor preferences for reaching separate individual workout agreements, rather than global agreements. Creditors consistently demonstrate a strong desire to avoid master creditor agreements which extend over a long period of time. Each plan, therefore, should seek to accommodate the individual creditor relationships to the maximum possible degree through consistent treatment and, if possible, to accomplish satisfaction of undersecured or unsecured claims through available assets which can be segregated on a fair and equitable basis. Only where unsecured and undersecured claims cannot be satisfied in this way should a collateral pooling mechanism be utilized. Creditors will often prefer to waive their unsecured claims or undersecured claims to avoid the complication of participation in a complex collateral pool or they will be willing to advance new funds outside of the collateral pool context, but subject to a requirement for additional collateralization or specific cross-collateralization not related to the other unsecured or undersecured claims, in effect, creating individual creditor-by-creditor collateral pools. An important component of the plan will be to clearly communicate to the creditors that undersecured or unsecured claims can be waived, or collateralized, if new consideration is given. In addition, if there is enough collateral to go around, and if it can be divided equitably and if there is an incentive to the debtor to go through with this process, a master, or global collateral pool may not be required.

The purpose of a collateral pool is to effect a mechanism to capture equity for repayment of unsecured or undersecured creditors, subject to any reasonable residual incentives reserved to the debtor. Collateral pools are an important plan component in consensual reorganizations, but are not absolutely necessary if claims can otherwise be satisfied on a fair and equitable basis.

A consensual workout plan is no panacea. There is no magic to the process; just the hard work of uncovering, organizing and recording the economic and legal facts, developing a detailed knowledge of the circumstances and communicating these clearly and persistently to the constituents of the plan. The legal and economic facts will define the plan, and internal and external relationships will be changed, based upon the development of these factual and legal positions. Development of a consensual workout plan is difficult and requires the alignment of a large number of disparate parties, each of whom undoubtedly will recognize some change in their legal and economic position from the position they thought they had before the process began. Those changes must be accepted and alternative decisions based on the commonly understood legal and economic facts must be measured, in each case, against the legal and economic alternatives, the anticipated effectiveness of the workout plan and its cost measured against the cost of alternatives. Where there are reasonable prospects for the development and execution of a consensual workout plan, both the creditors and the debtor have the duty to pursue it and to honestly and vigorously seek its implementation.
VII. Impact on Creditors.

Lessons learned by federal regulators in the Texas experience and in New England were applied with swiftness to banks in other regions of the country. Regulators relied heavily on the doctrine of bank safety and soundness in order to halt practices to which it objected. Prior to the Texas experience, the application of the standard of safety and soundness was unclear when applied to real estate loan portfolios and OREO and by extension to LBO portfolios. Although no clear consensus has yet developed in the courts, the application of the standard now has much more focus.

The statutory underpinning of safety and soundness is found in 12 U.S.C. § 1818, which authorizes federal banking agencies to take enforcement action necessary to halt unsafe and unsound banking practices. Such enforcement actions range from informal administrative action, such as letters of commitment or board resolutions, through memorandum of understanding to cease and desist orders. These documents require the bank's board to direct specific positive action by management and proscribe continued unsafe and unsound practices and violations of law. The consequences of engaging in practices found to be unsafe and unsound or in violation of law can include restitution for losses by and/or civil monetary penalties against and/or temporary or permanent disbarment from the banking industry of members of management and the board of directors. Enforcement actions often contain allegations of violations of law, fraud and breach of fiduciary obligations by directors and officers. The Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Crime Control Act of 1990 (CCA) greatly expanded the enforcement authority of regulators and increases civil penalties for violations.

Regulators applied the standards of safety and soundness subjectively based on a retrospective factual analysis. Consequently, bank management and its board of directors were required to be proactive and anticipatory in demonstrating to regulators their awareness of and serious concern for safe and sound practices. This awareness and concern must be carefully documented. For example, documentation should show that the board and management are aware of the effect which explosive growth in non-performing assets can have on the financial condition of the bank. It should show that management has examined and evaluated alternative courses of action. It should demonstrate that a specific course of action has been adopted and put into effect. Most importantly, documentation should demonstrate that the board and management have exercised reasonable business judgment in dealing with the problem. Reasonable business judgment is generally regarded as the ultimate standard to which management may be held accountable. However, some recent public sentiment indicates a call for a higher and more rigorous standard of care by management in dealing with other people's money. Unless or until the requirement of a higher standard of care actually develops, the reasonable business judgment should be the test of managing the bank safely and soundly.


The early 1980's, late 1980's and early 1990's in the Southwest, New England and the Middle Atlantic states, clearly demonstrated that the excesses in real estate, LBO's and ill-conceived mergers had created an absolute loss in value in many assets which were collateral for banks' loans. This loss was systemic and unavoidable. It could not have been escaped by "better underwriting." Indeed, underwriting to a large degree had become irrelevant.

Thus, the task of bank asset management is to shift this unavoidable loss to others and away from the bank to the greatest extent possible.

The shift of loss may be to the debtor or it may be to his other creditors who are not as aware nor as proactive as bank.

VIII. Basic Principles of Loan Restructures.

A. Balancing Collection Efforts with Effect on Bank Results.

   - Banks are guarded by rating agencies and bank stock analysts on current and projected levels of nonperforming assets ("NPAs") compared to total assets, loss reserve and capital. High ratios cause higher cost of funds.
   - Thus, management is deeply concerned about NPAs and reserves.
   - The real loss is the ultimate loss on an asset. The rest is interim accounting.
   - So which is more important? How do you balance these concerns?
   - Establish a clear rule.

2. Regulator Confidence.
   - Importance
   - Benefit of doubt in close calls.
   - Higher cut-off.
   - Examiners examine from centralized, organized files. Examiners give no credit for what's in your head or your desk file.
   - Knowledge of credit and pursuit of a proactive plan action must be demonstrated by road map memos.
   - Examiners are the most experienced reviewers of appraisals today.

   - Identify potential credit watch banks with regional statistics on vacancy, rent rates, absorption, general business conditions and job creation.
   - Are particularly interested in bank's tracking systems and early proactive address of problems.
   - Can have as much effect on bank earnings and capital as the examiners.

B. Important Accounting Issues and Their Effect on Workout Action.

Although Mexico and many Latin American countries do not follow U.S. Generally Accepted Accounting Principles (GAAP), on March 11, 1996, officials at the Mexican National Banking and Securities Commission announced that by January 1, 1997, Mexican banks would be following accounting standards much closer to GAAP standards. When implemented, "[a]ccording to Jose Garcia-Cantrera, Latin American bank analyst at
Solomon Brothers, the new accounting rules could mean that past due loans increase by as much as 100 percent, which would cut in half the amount of reserves has against loans in default." (Reuters, March 11, 1996, Mexico City). Suddenly, GAAP accounting issues are of immediate importance to Mexican bankers and borrowers.

1. **Capitalization of interest.**

Capitalized interest on loans is defined as uncollected interest which is added to the unpaid principal balance in accordance with a contractual loan agreement.\(^{81}\)

It is common in construction lending for the loan agreement to contain a line item loan allocation for the costs of construction. One of the line items is often an "interest reserve" out of which advances are made periodically to pay interest charges on the outstanding balance of the construction loan. When construction is complete and all line item allocations including the interest reserve are fully advanced, the loan is repaid through permanent financing or sale of the project in the normal course of business. The result, of course, is that the loan including the interest allocation is paid.

Capitalized interest concerns arise when the project loan is not paid at maturity through permanent financing or sale as was expected. In these cases, the "interest reserve" has been fully advanced, the loan has matured, but the source of repayment is delayed. If the loan is renewed pending receipt of the source of repayment, the interest reserve by definition has been capitalized into the loan.

Another situation causing interest capitalization concerns arises from opening a new loan or increasing the original loan to create a new interest reserve to carry the renewed loan pending its repayment. Depending on the source of repayment of the new loan, it too may be deemed capitalized interest on the original loan.

Capitalization of interest for reporting purposes is appropriate only when the borrower has the ability to repay the debt in the normal course of business.\(^{82}\) The preceding sentence does not mean that any construction loan which is not repaid at maturity must automatically be placed on non-accrual. It is not unusual in the real estate development business for permanent financings and sales to be temporarily delayed and for additional well structured loans to be extended to pay interest on the original loan during the delay. The purpose of this section is to give workout officers guidance on the circumstances under which continued accrual is appropriate.

Capitalization of interest on short term real estate loans should be based upon the borrower's ability to discharge the indebtedness in the normal course of business considering the surrounding circumstances and based upon prudent credit judgment including source of repayment and value of collateral.

The appropriateness of interest capitalization for accounting purposes is based primarily on the creditworthiness of the borrower and guarantors. In addition to the general criteria for creditworthiness, the following questions should be considered in determining whether capitalization of interest is approbiable:

a. Was interest capitalization anticipated upon approval of the initial loan?

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81. OCC Examining Circular 229.
82. Id.
b. Is the loan well secured (i) by collateral that has a realizable value sufficient to discharge the debt (including capitalized interest) in full, or (ii) by the guaranty of a financially responsible and capable party?

c. Is repayment of the loan based upon a reasonably ascertainable event in the future?

d. Can the borrower obtain funds from sources other than the bank on similar terms and rates?

e. Is there little or no doubt as to the ultimate collection of all principal and interest?

If the answer to these questions is predominantly affirmative, then capitalization of interest may be acceptable. The primary test remains the overall credit quality of the loan. Credits of sound quality may merit interest capitalization even if some of these questions are answered negatively. However, only in very unusual circumstances will a loan classified substandard merit interest capitalization.

2. **Insubstance foreclosure (ISF).**

Loans should generally be considered insubstance foreclosures where they meet all of the following criteria:3

a. The debtor has little or no equity in the collateral, considering the current fair value of the collateral; and

b. Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; and

c. The debtor has either:

i. formally or effectively abandoned control of the collateral to the creditor, or

ii. retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

The first two criteria are used to identify situations where most of the risks and rewards of ownership of the collateral have passed from the borrower to the bank. Even if the value of the collateral securing the loan has dropped so that there is little or no equity in that particular investment, the borrower or guarantor may currently have demonstrable sufficient strength or outside sources of cash to service and eventually retire the debt. In such case, the second criteria is not met and there is no insubstance foreclosure. Thus, value of collateral for a secured loan may drop to zero without a finding of ISF if the borrower or guarantor has the demonstrable current wherewithal to repay the loan from other sources. Likewise, if all loans to a borrower are cross collateralized and total debt is reasonably exceeded by the value of all cross pledged collateral, then the first criteria is not met and there is no finding of ISF.

The third criteria leaves room for subjective evaluation of the borrower's ability to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future. This subjective evaluation should be prudently exercised by the workout officer and management. For example, when using forecasts to assess the borrower's ability to repay the loan or to assess the prospects for improvement in the value of the collateral, the workout officer making the determination should be mindful that the longer the time projected, the less reliable the projected results. Projections should be reasonably near term and be based on independently derived supportable assumptions.

Workout officers should be cognizant that determination of ISF affects only the bank's accounting for a loan as substantially repossessed. Legal title to the asset remains in the borrower until it is passed to the bank either consensually or through foreclosure. The loan is not in default solely by being found to be an ISF. It may be in the bank's best interest to obtain control over the price and timing of the sale of the collateral to eliminate an asset acquired for debt previously contracted as soon as possible, but action must be taken in a way to protect the bank from lender liability allegations. Therefore, it is extremely important for lending and supervised workout officers to maintain a course of dealing that minimizes the bank's exposure to such allegations.

Even though an ISF real estate loan must be accounted for as OREO, compliance with 12 U.S.C. § 7.3025 is limited to the initial appraisal and annual reappraisal of the value of the underlying real estate. It is not necessary to obtain prior regulatory approval to fund a borrower's draw request\(^8^4\), although the bank may opt to refuse such funding under its loan agreement if the loan is in default.

3. Troubled debt restructures.

A troubled debt restructure (TDR) is one "in which the bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider."\(^8^5\)

Basic knowledge of TDR accounting is important to workout officers in (a) preventing nonaccrual status for certain loans and, (b) restoring existing non-accruals to performing status. A finding that a restructure is a TDR requires the restructure to be carried on the bank's financial statement as a nonperforming asset even if the loan is current as to interest. TDR's are governed by FAS 15\(^8^6\) which is extremely complex. This section undertakes only to outline the basic rules of TDR's and make certain suggestions rather than attempt a comprehensive review of FAS 15.

The point is to make workout officers aware that a restructure that makes perfect business sense may nonetheless be deemed a TDR by the bank's independent accountants with the result that the goal of reducing non-accrual assets is not achieved. However, the work-

\(^8^4\) Conference with legal staff OCC Southwestern District Office.
\(^8^5\) Banking Circular 195, May 1, 1985, emphasis added.
\(^8^6\) Statement of Financial Accounting Standards No. 15.
out officer should not negotiate a less favorable business deal in an attempt to achieve more favorable accounting treatment.

Because of the complexity of FAS 15, the advice and counsel of the bank’s internal accounting staff should be sought as soon as a plan begins to take shape and before commitments are made to the borrower.

Note from the underscoring in the definition of TDR that the touchstone is granting concessions because of the borrower’s difficulty. For example, extending a loan at an interest rate equal to that generally charged for loans with similar risk would not be a TDR even if the rate were lower than the rate on the original loan.

If the new terms of the troubled debt restructuring provide for a reduction of either interest or principal (referred to as a modification of terms), FAS 15 requires that the recorded amount of the loan on the bank’s books (principal plus accrued interest) be compared to the total future contractual cash payments (including both principal and interest) expected to be collected. A loss is recognized only if the total of such future combined payments is less than the recorded amount of the loan. Otherwise, no loss is recognized and the only additional accounting requirement is to determine the new effective interest rate for income recognition purposes. However, the restructured loan will be carried as a non-performing asset.

Often, the new effective interest rate is equal to the stated loan rate included in the restructured loan document. However, adjustments may be required if (a) the loan principal is reduced, (b) the new contractual rates are on a graduated basis (e.g. 8% first year, 10% second year, etc.), (c) due and unpaid interest is not added to principal or otherwise included in the contractual interest rate amount, or (d) the repayment terms have other unusual provisions. If an effective interest rate computation is required, it should be based upon future contractual payment terms excluding all payments which are contingently payable. This rate is calculated so as to yield a constant rate of interest over the remaining life of the loan. It is expected the rate will generally be less than the original loan rate and may be as low as zero without any requirement to recognize a loss.

Subject to the rules on capitalization of interest discussed in Section VII B(1), infra the bank may extend additional credit to a borrower at interest rates below the current market rate. Since this is a new loan to the same borrower, no special accounting rules apply. Accordingly, discounting or loss recognition is not necessary. However, if the new loan is granted in connection with the restructuring of an existing loan, it will be considered part of the restructuring and accounted for as previously described.

In all troubled debt restructuring the collectibility of future payments may be questionable. Therefore, a credit analysis should be performed to determine if any additional amounts should be charged to the allowance for loan losses. The analysis should include the borrower’s ability to meet the new terms of the loan based upon projected cash flows, profitability and other credit factors.

C. HOW TO FORCE HIDDEN PROBLEMS TO THE SURFACE.

1. **Strict Enforcement of Loan Agreement.**
   - Require full compliance with all conditions to new advances (advising borrower, if necessary, that any prior waiver of certain conditions will no longer be granted).
   - Make sure that financial statements and borrowing base/construction progress
reports are provided on time and accompanied by any required certificate of compliance.

- Obtain detailed computation of any financial covenants required by loan agreements, such as current ratio, leverage ratio, tangible net worth, etc.
- Obtain on a regular basis agings of all payables and receivables and an analysis of concentrations.
- Inspect borrower’s book and records and properties as permitted by loan agreement.

2. **No Reallocation.**

In order to keep a loan on accrual, the lending officer is sometimes tempted to reallocate from, say, the tenant finish line items to the interest reserve after the initial interest reserve has been depleted. The debtor will offer convincing arguments that tenant finish requirements are lower or will be paid by the tenant. This type of action hides problems because the tenant finish is always higher than originally projected, not lower.

3. **Borrower’s Deposits.**

Borrower deposit requirements are included in loan agreements to capture the borrower’s cash into a project as soon as a line item cost overrun is known. Failure to exercise this right allows the borrower to divert his cash to other uses thus exposing the bank to additional cost and probable loss to complete the end of the job.

4. **Borrowing Base Overadvances.**

A clear sign of problems in an accounts receivable and inventory financing is when the borrowing base report, either directly or indirectly through an analysis of specific items contained therein, discloses that the principal balance of the loan exceeds the stipulated borrowing base. In nearly all situations, the borrower will argue that the overadvance is temporary in nature and will correct itself over time so that a waiver should be granted. In the overwhelming majority of cases, the overadvance will not cure itself over time, and the bank is well advised not to grant the waiver unless the borrower makes specific concessions designed to protect the bank’s interests (e.g., lock box, additional collateral and/or personal guaranties).

5. **Breaches of Financial Covenants.**

A primary purpose of financial covenants in a loan agreement is to provide an early warning signal of a borrower’s potentially serious financial difficulties. Clearly, the financial covenants will fail to serve such purpose if their breach is treated by the bank as a mere “technical” default and readily waived. The breach of any financial covenant should be carefully analyzed to determine if it represents an isolated occurrence based on special circumstances or is indeed a harbinger of future distress for the customer (and bank). If such breach raises concerns, consideration should be given to obtaining specific concessions from the borrower in exchange for granting a waiver. In any event, the waiver should always be given in writing and make clear that it applies only to the specific date or period involved.
D. Understanding Economic and Market Forces.

1. Market for the Product.

In troubled real estate markets, the debtor often depletes his resources in covering overhead or feeding projects with perceived positive potential. He has little left to support the bank's projects.

In these cases, the bank's primary source of interest carry and principal payment is the collateral itself. Thus, it is critical for the workout officer to know how to evaluate the project. This is discussed in detail in Section VIII, infra.

2. Current Feasibility.

Appraisals are important in evaluating collateral, but appraisals do not produce the cash to repay a loan. They only give an indication of what the collateral is worth on the day of the appraisal. Consider that appraisals are for accounting purposes. The workout officer needs to know current feasibility of the project. This is also expanded in section VII.A.3, infra.

3. Lease Rules.

- Importance of bank approval rights.
- Effect on value and salability.
- Free rent rules.
- Lease profitability rules.

4. Sales of Subsidiaries.

In many highly leveraged transactions, it is common for the lender to require the parent company borrower to grant liens in the stock or assets of subsidiary companies. While the cash flow of the consolidated group may be sufficient to pay interest on the loan, the sale of one or more subsidiaries may be needed to make principal payments. The sale of subsidiaries may not have been contemplated at the time the leveraged buyout originally occurred. In any case, the workout officer must carefully analyze the potential value of various subsidiaries and their prospects for sale, taking into account that the overhead charges allocated by the parent company to such subsidiaries may skew their apparent operating results. Such analysis will require a review of consolidating financial statements as well as the possible retention of an industry consultant.
E. Bank's Rights to Collateral.

1. Negative Pledges.

The bank may have required a "negative pledge" which, although not acquiring a lien against the assets, limits the debtor's right to dispose of or encumber certain assets. The theory of a "negative pledge" is that the debtor agrees with the bank that it will not sell, lease, convey, or otherwise dispose of specified assets of the debtor or permit to exist any encumbrances with respect to such assets. The negative pledge may be coupled with the debtor's agreement to provide collateral to the bank (i.e., that the debtor will execute documents necessary to grant the bank a lien against certain property) upon the happening of certain events which typically may be tied to circumstances evidencing a deteriorating financial condition of the debtor. This type of arrangement may provide little comfort to the bank if the loan becomes troubled. To the extent that the debtor may be in default for failure to make any required payments to the bank or is otherwise in default to the bank, the debtor may have little motivation to deliver the requisite lien documents at that point, as its failure to do so will simply be another event of default. The bank may be in no better position than it would be if the loan were "unsecured," although the bank could perhaps argue that the debtor's agreement and obligation to provide collateral is specifically enforceable or that the collateral is held in a constructive trust for the benefit of the bank. Significant litigation expense would likely be incurred in such cases.

2. Assignment of Partnership Interests.

In a restructure or in connection with the original loan, the bank may attempt to obtain or may have obtained a collateral assignment of a partnership interest held by the borrower. The assignment of the partnership interest should in most cases be a collateral assignment (security interest or lien on the partnership interest) and not an absolute assignment (bank owns partnership interest) in order to avoid obligating the bank for any partnership duties or liabilities. Prior to obtaining an assignment of a partnership interest, the partnership agreement should be reviewed with the bank's counsel in order to determine any issues relating to partner's consents to a transfer, securities law restriction and future capital contribution obligations of the partner. The collateral assignment of the partnership interest typically will provide the bank with a more valuable asset - the entire equity interest - than simply an assignment of proceeds from the partnership interest.

3. Assignment of Proceeds.

In connection with a restructure, a bank may attempt to obtain an assignment of proceeds from certain collateral, typically a partnership interest or some types of contracts (e.g. lot sale contracts, income generating service contracts). The assignment of proceeds will typically only provide the bank with remedies or recourse in the event proceeds are received by the borrower from a partnership interest or from contracts and such proceeds are not delivered to the bank. The bank will not have obtained a security interest in or lien on the actual interest which produces the proceeds, so the true balance sheet value of such an assignment may be nominal. In certain cases (e.g. service contracts) the bank may very well not want to obtain an assignment of a contract so as not to impose liability on the
bank. One other consideration is that if bankruptcy is likely the proceeds received by the bank within the preference period prior to bankruptcy may be required to be disgorged.

(4) Liens, senior and subordinate.

Typically, the bank will obtain a first or senior lien on the primary collateral for its loan. In many instances, either in obtaining additional collateral for the original loan or in shoring up a troubled loan, the bank may have acquired a subordinate lien on an additional piece of collateral. The subordinate lien would be subject to one or more prior liens in favor of other creditors. An analysis of the actual value of the subordinate lien must include consideration of the total value of the collateral, the amount of debt secured by senior or prior liens against the collateral and the actual willingness of the bank to advance funds to protect its interest in the collateral in the event the borrower is in default in payments to a senior lienholder or in the event the senior lienholder exercises remedies against the collateral. Another consideration in the use of a subordinate lien is to "tie up" the collateral so that no consensual sale or conveyance of the collateral by the borrower can occur without the bank having the opportunity to require payment of the proceeds from the sale of the property to the bank prior to the release of its lien.

5. Related personal property.

Often loans secured by real property will be additionally secured by personal property and fixtures used in connection with the real property. The bank should have valid security interests that have been perfected by financing statements currently filed and effective with the property filing offices. Liens on personal property are extremely important in relation to multifamily properties and hotel properties.

6. Remedies under UCC Article 9.

Upon default in a loan secured by personal property which is subject to a valid and enforceable security interest under Article 9 of the Uniform Commercial Code, Article 9 affords the secured creditor the following non-judicial (i.e., self-help) remedies:

a. right to notify account debtors to make payment directly to the secured creditor;

b. right to repossess tangible collateral without causing a breach of the peace;

c. right to require the debtor to assemble the collateral and make it available at a reasonably convenient location designated by the secured creditor;

d. right to retain the collateral in satisfaction of the loan; and

e. right to sell, lease or otherwise dispose of the collateral by public or private proceedings.

The most significant remedy available under Article 9 is the secured creditor's right, after giving prior notice to the debtor and certain other interested parties, to conduct a private or public sale of all or a portion of the collateral without any judicial involvement.87

87. UCC § 9-504.
While the power of sale under Article 9 represents an efficient method of liquidating collateral, there is imposed on the secured creditor the responsibility of assuring that every aspect of the sale if conducted in a "commercially reasonable" manner. Article 9 does not expressly define what constitutes "commercially reasonable" conduct, and litigation has frequently resulted seeking to determine whether a secured creditor's conduct was commercially reasonable in the specific circumstances presented. The importance of conducting the Article 9 sale in a commercially reasonable manner is that the secured creditor who fails to meet this standard may be denied the right to pursue any deficiency claim against the debtor or any guarantor and may be restrained from or ordered to conduct the sale in a specified manner or be liable for damages.

7. Bank's remedies - local law determination.

The determination of the specific legal remedies available to the bank in the event of a loan default is made under the local law of the governing jurisdiction and is an inherent part of that state's economic and political structure. The workout officer must consult with the bank's legal department and local legal counsel to ascertain the legal advantages and disadvantages of specific workout structures and enforcement strategies.

F. Overview of Borrower's Problems.

1. Federal income tax liability.

A properly counseled debtor will first be concerned with his liability for income tax arising from involuntary or voluntary conveyance of title to collateral or from forgiveness of debt. Income tax planning is a very significant element of virtually every real estate workout. In fact, in many workouts, the tax considerations become the single most important factor in developing a strategy and ultimate consummation of the workout. Although certain taxes incurred more than three years before the filing of a bankruptcy petition may be dischargeable in bankruptcy, more recent federal income taxes, including taxes generated pursuant to the transactions involved in the workout, are not dischargeable. Consequently, it may be advisable for the debtor to pursue virtually any course that would minimize federal tax liabilities, including incurring additional personal liability which may be subsequently discharged in bankruptcy.

a. Information To Be Gathered.

In order to apply the foregoing legal principles and to further develop the strategies described below, the following information must be examined:

i. A detailed description of each asset owned by the debtor, including its fair market value, adjusted tax basis, and usage by the debtor (i.e. investment, personal, trade or business, inventory, etc.).

88. UCC § 9-504(3); see also UCC § 9-507(2).
89. UCC § 9-507.
ii. A detailed description of all fixed and contingent liabilities of the debtor, including whether they are recourse or non-recourse, guaranteed, seller-financing, etc.

iii. All agreements relating to the assets and liabilities of the debtor, including notes, loan agreements, guarantees and partnership agreements.

b. Analysis and Strategies.

In a comprehensive real estate workout, the following steps of tax planning and analysis must be taken:

i. Evaluate the market value, indebtedness and adjusted basis of each property and determine the taxable gain or loss that would be recognized upon the voluntary or involuntary conveyance of each such property.

ii. Determine the taxable income of the debtor for the current taxable year to date and project the taxable income for the remainder of the year, other than income or loss that may be generated upon the disposition of the real properties.

iii. Determine the solvency or insolvency of the debtor.

iv. Determine the practical likelihood of bankruptcy and the willingness of the debtor to consider bankruptcy.

v. Consider and plan for the amount of gain or loss and timing of disposition of each and every property of the debtor.

2. Reputation, future earning power and family.

A debtor will be concerned with his reputation in the community since it will greatly affect his ability to earn money in the future. These concerns are driven by his perceived need to preserve a reasonable life style for himself and his family. These are powerful psychological motivations and should not be treated lightly by the workout officer.

3. Alternatives.

Absent fraud or other malfeasance, a borrower can accomplish his objectives by filing for bankruptcy, an action which is expensive and time consuming for the bank, invariably leads to greatly reduced value of collateral if the stays are finally lifted or may expose the bank to a cram down plan of reorganization resulting in write downs and permanently nonperforming assets. Thus, heavy handed action by a workout officer without consideration of the factors described above can adversely affect the bank. Conversely, if the bank is an undersecured or unsecured creditor, it may prefer the debtor to be in bankruptcy in which case a different approach is appropriate. As noted in section VIIIA., infra the facts generated in connection with the initial analysis of the existing status of the credit will dictate the workout plan.

G. Basic Workout Strategy.

Time is always critical. First, it is important to the bank’s well being that nonperforming and classified assets be reduced quickly. Second, if the workout plan requires foreclosure and resale, ultimate actual loss is minimized by doing so as quickly as possible espe-
cially in a deteriorating market. Finally, the bank is greatly benefitted by achieving its workout before other creditors are mobilized.

It is imperative to understand the bank's plan and focus on alternatives for achievement of the plan. The workout officer should prioritize actions to achieve the plan and move quickly and effectively with these actions. Remain calm and cool; avoid recriminations in meetings and exchanges where the borrower or guarantor face the same facts you have uncovered. Do your best to avoid exchanges of legalism which polarizes the objectives. Seek to align the borrower's and guarantor's plan with that of the bank. The officer should remember to stick to the loan documents and the bank's legal position within the context of the bank's plan. All parties should focus on a resolution and not waste money and time arguing about "who shot John."

1. **Objective: Prevent Non-Performing Asset Classification.**

The first goal of every workout plan is to prevent the subject loans from being placed on non-accrual or to restore the subject loans to accrual status, if possible. If accrual is not possible, then the plan goal is to minimize interim charge-offs and ultimate actual loss.

2. **Downside Protection.**

It is axiomatic that the lender who (1) addresses problems with the debtor first, (ii) acts consistently and in good faith, (iii) addresses debtor concerns, and (iv) is knowledgeable, reasonable and creative will achieve a better solution to a troubled credit whether that solution is loan restructure or amicable acquisition of title to collateral. Debtors, however, are not always cooperative. Thus, the workout officer must put the bank in the strongest position if restructure efforts fail and the relationship becomes acrimonious. Always first position the bank for maximum recovery if the events critical to the workout's success do not occur.

The following actions should be part of, or at least given consideration in formulating, every workout plan:

a. Find the best available collateral and get it pledged to support future value declines, accrued unpaid interest or possible working capital loans. The best collateral is that which produces income in addition to value.

b. Get all unsecured debt secured by anything of real value immediately.

c. Control the cash flow of the bank's collateral by entering into a cash collateral agreement with the debtor under which he pays over monthly to the bank all net operating income without deduction for capital improvements, taxes or insurance. The expense component of monthly NOI should be tightly negotiated and the debtor should agree to strict accounting subject to audit by the bank. Refusal of the debtor to comply with these requirements is a clear indication of bad faith necessarily requiring the workout officer to control cash flow through the bank's legal remedies.

d. Get all loans to the debtor cross collateralized and cross defaulted as an early objective. If cross collateralization cannot be obtained at the asset level because of ownership by partnerships without common partners, at least obtain cross collateralization of all the common partnership interests. The workout officer can expect a sophisticated debtor to use granting of cross collateralization as a bargaining chip,
for example, for a working capital loan or release of liability. Any other deficiencies discovered in the analysis of the documentation should be corrected in any restructure modification agreement relating to a troubled credit.

e. Get the bank's deal done before other creditors wake up. Start the preference period running.

3. **Press remedies in the documents.**

Correctly drafted loan documents will provide for non-monetary covenants, undertakings and representations and warranties by the borrower. Non-compliance with these provisions usually constitutes a default after appropriate notices to the borrower and his failure to cure within the time limits provided. Often it is necessary to get the attention of an uncooperative borrower by methodical enforcement of the bank's rights and remedies under the loan documents. Such enforcement should stay strictly within the bounds of the documents (e.g., written notice, grace period, etc.) in order to avoid allegations of lender liability. By demonstrating its seriousness through methodical enforcement of rights and remedies, the bank encourages the borrower to be willing to negotiate restructure.

Even after restructure negotiations begin, the bank should continue to give all notices and other actions required of it by the documents. The bank can always suspend legal enforcement if negotiations are proceeding satisfactorily, but not lose time (and money) through a "start-stop-start" approach to enforcement if negotiations break down.

To avoid surprising the borrower (which often leads to emotional allegations of bad faith by him), the bank should inform the borrower at the outset of negotiations that it intends to follow this dual track course of action (legal enforcement while simultaneously negotiating).

4. **Encourage borrower's proposals.**

The borrower should be encouraged to propose solutions to the problem. By encouraging borrower's proposals the workout officer keeps the borrower involved and obtains insight into the borrower's management ability.

5. **Be responsive, but firm and skeptical.**

Be skeptical of the debtor's optimistic projections of lease up, rent rates, low tenant finish requirements, sales volume, sales prices and operating income. The market is *always* worse than the developer perceives. Feasibility analysis previously ordered will give the workout officer his own independent realistic view of the market. The restructure should be based on the realistic view.

Set performance benchmarks in the restructure which the debtor must meet to earn the right to continue the workout. Make them reasonably achievable, but not easy. Often the debtor will propose a "cash flow" mortgage to the bank. In all but the rarest circumstances, the workout officer should reject such a proposal. Cash flow mortgages leave the debtor in control of timing and pricing of sale, give him the opportunity to manipulate net operating income to the disadvantage of the bank (even if he has executed a cash collateral agreement) and leave the bank with all of the risk of value decline either from market deterioration or from debtor mismanagement. If a cash flow mortgage is accepted, it must be
made "defaultable" by requiring a minimum monthly payment regardless of cash flow and prompt payment by the debtor of taxes and insurance.

Some debtors with many lenders will propose a consensual reorganization of their business in an attempt to reach a global resolution of all their debt, see Sections V and VI, supra. Even though these plans usually involve cash flow mortgages (called "pass-throughs"), they should not be rejected out of hand. Features of such plans also include a "collateral pool" into which the debtor places all of his business assets for the benefit of all of his creditors and usually involve partial or complete release from liability. The plan requires equal treatment of all creditors and full disclosure. They are similar in many respects to bankruptcy but without judicial supervision. If the bank is under secured even after cross-collateralization, it may be beneficial to consider consensual reorganization to gain access to the collateral pool. The plans are extremely complex and should be discussed thoroughly with the workout officer's manager.

6. One broken promise for another.

Do not trade one broken promise to pay for a new promise to pay. Always obtain something tangible for any concession, however small.

7. Borrower's affidavits.

When problems begin to arise with respect to a lending relationship, a bank finds it increasingly difficult to get current financial information from the borrower. Its borrower may well be encountering difficulties with other creditors and will want to reveal as little information as possible about its current affairs while it considers possible courses of action to protect its interests as against all creditors. The bank's ability to evaluate the status of the loan and the prospects for repayment are made more difficult by its inability to determine the overall financial condition of the borrower. It is essential that the bank obtain a full and complete disclosure of the financial condition of the borrower as a part of and as a condition precedent to any workout arrangement. The borrower should provide a detailed sworn financial statement which described and identifies all assets and liabilities and prior transfers of assets. The affidavit of financial condition, when examined against prior financial information received from the borrower, may assist the bank in identifying any fraudulent transfers which may have been made by the borrower and also should provide the bank with either support for the borrower's oral representations regarding its financial condition or reveal that the borrower has been untruthful or fraudulent during workout discussions. The borrower should be able to show that his financial affairs are such that a restructure of a problem loan can be successful in order for a bank to consider
that alternative. Likewise, to the extent that a borrower who claims to have few assets from which the creditor may recover seeks to be released from liability in consideration of his cooperating with the bank in the bank's realization on any collateral for the loan, the borrower should be able to evidence such financial condition to the bank.

H. TECHNIQUES TO MAINTAIN LOAN PERFORMANCE.

1. Unsecured loans, additional collateral, cross collateralization.

A primary objective in any workout is to improve the bank's prospects for repayment by obtaining any new collateral which is available to be pledged to it. In the case of an unsecured loan, obtaining collateral, even if it provides considerably less than full coverage for the loan, will be the only means of acquiring a specific source of repayment and prevents the bank from being treated in the same manner as the borrower's trade creditors who, in a bankruptcy context, will receive only pennies on the dollar.

Even if the bank's loan is currently secured, there may be additional collateral which is available to be pledged to improve the bank's secured status. Obviously, assets which are currently unencumbered are the best form of collateral. However, it may be extremely advantageous for the bank to obtain a lien against assets which have previously been encumbered since the current or future value of such assets may exceed the amount of the first lien. In evaluating the borrower's assets which may be available to serve as collateral, do not hesitate to be creative. For example, a borrower's intangible assets, such as patents, copyrights, trademarks, servicemarks and franchise rights, could be very valuable but may not have been taken as collateral by other lenders who only loan against "hard" assets.

An extremely important objective in any workout is for the bank to obtain cross collateralization of all of its loans. Cross collateralization means that particular assets serve as collateral for more than one loan or indebtedness. For example, if a bank's relationship with its borrower consists of a revolving line of credit secured by accounts receivable and inventory, a term loan secured by equipment and real estate an letters of credit secured by the proceeds of specific contracts, the workout officer's objective would be to revise the existing documents to make sure that all the assets which have been pledged by such borrower secure all three types of financing provided. The reason that cross collateralization is so important is that it will enable the bank to apply "excess" value attributable to collateral for one loan against the outstanding balance of another loan. Using the example discussed above, it is quite conceivable that if the borrower were to file for bankruptcy, its accounts receivable and inventory which secure the revolving line of credit would be insufficient to pay off such line of credit. On the other hand, liquidation of the borrower's equipment and real estate may result in proceeds in excess of the term loan. Unless the revolving line of credit and term loan were cross collateralized, the bank would not be entitled to apply the excess proceeds of equipment and real estate to the outstanding balance of the revolving line of credit, thereby resulting in a loss on the revolving line of credit which would otherwise be avoided.

2. Cash collateral agreements.

Often the bank will be faced, in a workout situation, with the opportunity to enter into an agreement with a borrower whereby the borrower will turn the revenues from the
property over to the bank and the bank will be allowed to deal with the property by taking control of the property and managing it prior to the time that the bank actually acquires the property pursuant to a foreclosure action. Generally, the bank is presented this opportunity in relation to income producing real estate, and it may appear to be an ideal way to obtain possession of the revenue from the property and protect the collateral pending foreclosure. When the bank and a borrower agree to this type of arrangement, they usually enter into a cash collateral agreement to govern the collection and application of the rents from the property. The borrower generally attempts to obtain a full release and an indemnification from the bank in relation to the activities of the bank during the period that the bank is in possession of the property prior to the bank’s acquisition of the property through foreclosure. Notwithstanding that a cash collateral agreement may seem to be the ideal arrangement in cases where the foreclosure process is lengthy, there are numerous pitfalls which the bank should consider.

Once the bank takes possession of the property it becomes a “mortgagee in possession.” This term has slightly different meanings in various jurisdictions; however, the principles and warnings set forth below are generally applicable. A mortgagee in possession is one who takes possession of property pursuant to a contract (e.g., a cash collateral agreement) and is entitled to remain in possession until the bank’s debt is paid in full.

Generally the standard of care of a mortgagee in possession is that of a constructive trustee and the mortgagee is under a duty to manage the property in a reasonably prudent and careful manner in order to keep the property in a good state of preservation and to make it productive. When a mortgagee comes into possession of the property in other than a lawful manner, then the mortgagee generally is responsible for the reasonable rental value of the property, if any, during the time the mortgagee is in possession. If the mortgagee’s possession is lawful, then the mortgagee must account for the rents and profits received or which might have been received by the use of reasonable diligence and care. The mortgagee in possession may be liable as the landlord under the lease that cover the property and will be liable for negligent acts occurring on the property. Indemnities from borrowers are generally of little or no help in protecting the bank; however, insurance can cover some of the risk assumed by a mortgagee in possession.

Because of the bank’s control over the borrower and the property resulting from its being a mortgagee in possession, there are number of lender liability concerns which should be considered. If a borrower subsequently seeks the protection of the bankruptcy courts and the bank is found to be in control of the borrower’s business, the bankruptcy court has the power to “equitably subordinate” the bank’s lien to the liens of other creditors. If the bank is found to be in control of the borrower’s business, it can be held liable under federal and state environmental statutes for the cost of cleanup of various hazardous wastes. Certain liability for federal withholding taxes also can be successfully asserted by the Internal Revenue Service if the bank controls the borrower’s business. In addition, notwithstanding the fact that the bank may act properly, a borrower seeking to prevent foreclosure may raise allegations of improprieties related to the bank’s possession of the property which the borrower may allege prevented the borrower from making payments on the debt.

There are circumstances when the bank will clearly desire to become a mortgagee in possession (e.g., where the borrower has abandoned the property). However, in most cases careful consideration should be given to the facts surrounding a proposed cash collateral agreement and the circumstances relating to the collateral, especially in light of the numerous liabilities which inure to a mortgagee in possession. If the risks are such that a cash col-
lateral agreement is deemed to be appropriate and possession of the property is desirable, the provisions of the agreement with the borrower should be carefully drafted to protect the bank. The bank should attempt to structure a cash collateral agreement under which the borrower retains control of the property by leaving the borrower responsible for the management and operation of the property while obtaining the net revenues from the property.

3. **Loan splitting.**

A $10,000,000 loan on an office building which is producing $600,000 in NOI from credit tenants. No outside support available from the debtor/guarantor. No concessions on rate or terms other than extension of maturity are made. Can the loan be internally restructured on the bank's books as a $5,000,000 performing loan ($600,000/$5,000,000 = market rate) and a $5,000,000 non-accrual loan? Generally no. If there is no outside debtor/guarantor support and the building produces $600,000 in NOI, it will be difficult to show a value in excess of the $10,000,000 loan amount. These factors would combine to produce an insubstance foreclosure (See section VII B(2), supra). If an independent, accurate appraisal of the building showed value in excess of $10,000,000, then the workout officer should discuss the possibility of this internal "restructure" with the bank's internal accountants.

One exception to the general rule is a change in circumstance after the loan has been placed on nonaccrual and been charged down. For example, a new credit-worthy tenant could be obtained producing new cash flow which would carry and begin amortizing the loan as charged down. In such case, the loan may be returned to accrual.

4. **Trading borrowers.**

Original borrower arranges to sell project for amount equal to current debt to unrelated buyers. Bank agrees to finance 100% of purchase price for new buyers at below market rate but no other concessions such as limited liability to new buyers. The new loan is not technically a TDR under FAS 15 because it is not to the original borrower. However, the new loan may still be a non-performing asset if there was a finding that the original loan was an insubstance foreclosure because the downpayment requirement of 12 U.S.C. § 7.3025 and FAS 66 was not met. Even if there was no finding of insubstance foreclosure, the principal balance of the new loan may be required to be marked to market to reflect a below-market interest rate. These are only two of many complex considerations. Advice of the bank's internal accountants should be sought early on.

**Warning.** Workout officers are often tempted to negotiate with in-house and independent accounts to comply with the literal accounting rules and to twist the deal to meet accounting requirements. The new borrower immediately picks up on the bank's problems and extracts substantive concessions for his cooperation in helping the bank with its accounting issues. This often weakens the restructure and can lead to greater ultimate loss. Build hammers, not watches.

5. **Additional compensation for added risk.**

Obviously, if the bank structures a workout with the borrower that reduces the bank's current return, causes it current loss or exposes it to future loss, the bank should be and is entitled to a higher reward. The bank contracted for interest risk and interest reward. if
the bank's risk is converted to equity risk, it should participate to some degree in equity reward if such occurs because of a rising market.

However, the bank must beware of lender liability issues inherent in increasing its reward. The bank must maintain its position as a secured lender and not a partner of the debtor.


As an alternative to forced liquidation of assets and litigation, a bank may consider affording the borrower a reasonable period of time in which to market the property prior to the bank's ultimate enforcement of its remedies pursuant to the loan documents. The bank may assist the borrower in its marketing efforts by obtaining from the borrower a nonexclusive right to market the property. The bank must exercise care in this area to avoid the exercise of control over the borrower which could subject the bank to potential claims.

I. Borrower Conferences.

1. Purpose.

When arranging a conference with the debtor, the workout officer should specify the purpose of the meeting. The debtor should then be informed that the initial meeting will commence with execution of the pre-workout agreement which should be provided to the debtor in advance. He should be advised to come prepared to bring the bank up to date on his financial condition, cash flow, property status, other debt and other pertinent topics, and to present his own workout alternatives.

Debtors may approach this meeting with a "wait and see" attitude to get an understanding of what types of alternatives the bank will consider before they make a proposal. The meeting will be more productive if the workout officer encourages the debtor to make a proposal at the meeting.

2. How to Prepare.

In order to conduct a meaningful and fruitful working meeting, the workout officer must be prepared to enter into an open-minded discussion of the facts as presented by the debtor so he can fully understand the circumstances and review alternatives, some of which may be suggested by the debtor. By beginning the working conference in this manner, the workout officer can establish the "ground rules" for future discussions, the results of which will be more fruitful under these circumstances.

Because of the debtor's potential fears or anger, the conference may become antagonistic and unproductive. For this reason, the workout officer must have the discipline and professional attitude to maintain the purpose of the meeting and maintain the "ground rules" for meaningful resolution.

3. Use of attorneys.

Many conferences relating to workout resolution can be handled directly between the workout officer and the debtor. Depending upon the nature of the workout, the size of the
loan and the potential for non-accrual or loss, certain discussions should include an additional workout officer, preferably the group manager. If a debtor indicates he will arrive at a meeting with his attorney, the workout officer must review the situation with his manager to determine if it is appropriate for the bank to engage legal counsel at this juncture. By all means, when an attorney for the debtor is present, the workout officer should include in the conference his manager or legal counsel so two people are representing the bank.

Examples of instances when the meeting should include the bank's legal counsel follow:

- Debtor has made claims of lender liability.
- Litigation between the bank and the debtor is pending or being actively considered.
- Debtor has revealed plans to file bankruptcy.
- The workout officer considers there are issues for which a claim may arise in the future against the bank.
- Debtor's relationship is already antagonistic, in which case the bank may be best served by utilizing legal counsel as the primary contact with the workout officer support.
- A discussion of legal issues is expected.

Prior to the meeting, either the workout officer, his manager, or another workout employee should be designated as the person to take notes and prepare a follow-up memorandum summarizing the meeting.

4. **Topics for Discussion.**

Topics for discussion include:

- Status of debtor's loans with other creditors.
- Status of debtor's other real and personal property investments (leasing, cash flow).
- Status of pending transactions or litigation which may positively or negatively impact the debtor's financial condition.
- Possibility of raising additional equity, refinancing, sales.
- Future plans.
- Operating standards for the collateral property during the period of negotiations (What happens to the cash? Is the property secure?)

At the initial debtor conference, the workout officer should explain the bank's requirements regarding turnover of property NOI and present the debtor with the proposed cash collateral agreement discussed above. One objective is to make clear to the debtor that the bank intends to enforce its remedies thoroughly.

5. **Memorializing Meeting and Next Steps.**

Immediately after the meeting, the person designated to summarize the meeting in report form generates a report memo. The original of the memo should be sent to the Credit file with a copy sent to each participant. The memo should be factual, objective, and not draw any subjective conclusions as to the outcome of negotiations.

As a result of conferences with the debtor and his analysis of information provided, the workout officer will have obtained new information which must be investigated and
verified in order to fully understand the debtor's financial condition and the potential for repayment from liquidation or refinancing of the collateral. As the workout officer assesses certain key factors, and defines more clearly the particular problems, resolutions can then be developed.

Essentially, there are four options which can apply in a workout:

- Reinstatement of the loan.
- Restructure.
- Foreclosure.
- Negotiation of a deed-in-lieu of foreclosure.

As stated above, the workout officer must remain mindful of the bank's objectives and the debtor's concerns discussed above in developing his proposed resolution.

J. SETTLEMENT AGREEMENTS AND RELEASES.

If a bank and a borrower determine that the loan will be restructured, it is important that the parties focus on the lending relationship going forward and that any disputes which have arisen during the term of the loan be laid to rest. As a part of a bank's agreement to restructure a loan, the bank should require the borrower to release the bank from, and indemnify the bank against, all claims and causes of action which the borrower may have against the bank in relation to the loan arising prior to the time of the restructure.

To the extent that resolution of a problem loan involves the bank's foreclosure of its lien against property or a conveyance to the bank by deed in lieu of foreclosure, the borrower and any guarantors may have negotiated a release from all or a portion of personal liability in connection with the loan. To ensure that the borrower any guarantors do not interfere with the bank's exercise of its foreclosure rights, it may be appropriate to condition their releases on their not taking any such actions. Because the borrower's overall financial condition may be in jeopardy and there is the possibility of a bankruptcy filing by the borrower, it may also be appropriate to provide that the releases of the borrowers and any guarantors will not be effective in the event of a bankruptcy filing for a one-year or longer period following foreclosure to the extent that the foreclosure is set aside by a court of competent jurisdiction.

K. MULTI-CREDITOR LOANS AND RELATIONSHIPS.

There are several distinct types of multiple creditor loans. In the lending community the word “participation” is often used generically to describe a multiple creditor loan. However, it is helpful to categorize the types of arrangements between creditors. Loan participations are those loans where the “lead lender” sells a participation to one or more other creditors in the loan made by the lead lender to a borrower. A participation is evidenced by a participation agreement and a participation certificate executed by the participant and the lead lender. There is only one note and only one set of security documents. The participant's rights are contained in the participation agreement with the lead lender. A loan syndication, on the other hand, is an arrangement where each creditor has a direct-creditor relationship with the borrower. There are several types of syndications including agented credits, non-agented credits governed by an intercreditor agreement, and arrange-
ments where each creditor has a separate agreement with the borrower. The problems encountered by the bank in the workout of a multiple creditor loan vary depending upon whether the bank is the lead lender, a participant or part of a bank group governed by an intercreditor agreement.

1. *Considerations of lead lender or agent.*

Set forth below are some of the issues that should be considered by the lead lender or agent.

a. Documentation.

The bank should carefully review the documentation which relates to the participation or the syndication. The participation agreement, agent’s agreement or intercreditor agreement will spell out the duties and obligations of the lead lender in relation to the other creditors that are participants in the loan. A thorough understanding of the position of the lead lender or agent and its duties and obligations is necessary for the bank to proceed through the workout process. Under no circumstances should the bank take an action which is not authorized by the loan documents or the documents governing the multi-creditor relationship. The bank’s failure to honor the contractual obligations in the agreements can subject the lead lender or agent to liability to the other creditors and the borrower.

b. Is the Participation Interest a Security?

If the participation interest is characterized as a security, the lead lender may have other responsibilities to the participants in relation to the loan. The note or the participation agreement may be a security under the Securities Act of 1933 or the Securities Exchange Act of 1934. If the participation interest is a security, the offer and sale of the security would be subject to the anti-fraud provisions of the applicable securities acts. Whether the participation interest in any given situation is a security depends upon many factors. Even if an exemption is relied upon, the bank must be sure to make full disclosure to the participants at all times during the administration and workout of the loan.

c. Conflicts of Interest.

Generally, participations and syndications involve large lending relationships where the lead lender or agent has other loans to the borrower, guarantors, or affiliates of the borrower. Full disclosure of the lead lender’s relationships is essential when the loan is sold or syndicated. If during the workout process it is discovered that there is or were conflicts or potential conflicts, they should be dealt with openly and fully disclosed. It is important to remember that when the loan becomes troubled the participants will likely not share a common view as to what the proper course of action may be to resolve the problems with the borrower. The various participants will have different financial resources, different guidelines for loan workouts, different regulatory pressures and different concerns relating to earnings and liquidity.
d. Regulatory Guidelines.

There are certain regulatory guidelines with which the workout specialist should be familiar in this area. The Comptroller of the Currency, Banking Circular No. 181 (Revised August 2, 1981 and 1984) sets forth certain informational guidelines in relation to which the lead lender should supply information to the participant including (i) accrual status, (ii) status of principal and interest payments, (iii) financial statements, collateral values and lien status, and (iv) factual information in relation to the borrower’s credit standing. If these guidelines have been followed by the lead lender, it will be a better position when the loan becomes troubled.

If a loan was classified during the last examination, is in a non-accrual status, is in default as to principal or interest or has been renegotiated or compromised due to the weakening financial condition of the borrower, the loan is a ‘low quality’ loan, and the purchase or sale of the loan may be considered to be unsafe and unsound. Care should be taken not to participate or syndicate a loan that has any of these characteristics without full disclosure.

Loan repurchase arrangements will require the lead lender to include the amount for which the lead lender is obligated to repurchase as a part of the lead lender’s portion of the loan for loan limit purposes. Any obligation to repurchase (whether written or oral) will be treated as an extension of credit to the lead lender by the participant, and must be documented in writing and so reflected on the books and records of both creditors. Arrangements which provide that the participant’s interest will be funded and paid back on a last in-first out basis require the participant’s interest to be added to the lead lender’s portion of the loan for loan limit purposes.

The documentation between the creditors will not cover all of the issues that will face the lead lender or agent in the context of a workout of a troubled multi-creditor loan. Many of the issues which arise will require the creditors to resolve the practical business problems and make decisions that are beyond the scope or even the contemplation of the documents governing the rights and duties of the parties. The lead lender or agent must ensure that the decision-making process goes forward and that decisions are made by the requisite number of creditors (as provided in the documentation) in a timely manner. Often this will require great patience and negotiating ability.

2. Bank as a participant.

There are a number of concerns that the bank must be aware of when it is a participant in a troubled loan. The first thing that the bank must determine is the legal relationship between the bank and the creditor that sold the bank its interest. Depending upon the documentation, the relationship between the lead lender and the participant may be: (a) tenants in common, (b) trustee-beneficiary, (c) partners, (d) creditborrower, or (e) principal-agent. Generally, if the bank (as a participant) has purchased a partial or fractional interest in the loan, the bank will own the right to the bank’s proportionate share of future payments of principal and interest. The insolvency of the lead lender should not affect the bank to the lead lender which is unsecured (most participations that are not sales are unsecured or, at least, the security interest is unperfected), the effect of the insolvency of the lead lender may be fatal to the bank’s recovery.

With respect to a syndicated multi-creditor loan, if the bank holds its own note and is a party to each security agreement it should be well protected in the case of the lead
lender's insolvency as the insolvent lead lender should have no legal interest in the bank's portion of the loan. The agent agreement or the intercreditor agreement should deal with the administration of the loan in the event of the agent's insolvency or the insolvency of one of the creditors.

If the bank is a party to a participant agreement, the provisions of which indicate that the arrangement is a sale, the position of the bank should be fairly safe. There are certain risks of which the bank should be aware, however, and which it should attempt to protect against, including commingling the funds, (b) the note should either indicate the interest of the bank on its face or a third party should hold the note to avoid the risk of the lead lender transferring the note to a holder in due course, and (c) the participation agreement should be amended, if necessary, to allow continued administration of the loan in the event of the insolvency of the lead lender. If the bank is a party to a participation agreement that characterizes the arrangement as a loan by the bank to the lead lender, then the bank should seek to accomplish one of the following, if at all possible: (a) an amendment of the participation agreement to recharacterize the loan as a sale, or (b) assurance that the participation agreement contains an enforceable security agreement and perfection of the security interest, if possible, under applicable law. If these steps cannot be accomplished, careful negotiation with the lead lender that leads to a reworking of the intercreditor relationship will be necessary.

IX. Remedial Action by Banks.

A. INITIAL ANALYSIS AND EVALUATION.

1. Overview.

It is common for a troubled credit relationship to be transferred to the workout officer in a state of disarray. The workout officer is often faced with disorganized files, a fearful borrower/guarantor and no clear direction. The first step, then, in rehabilitating the relationship is to determine what the bank has in terms of collateral and outside sources of repayment and what the problems are. Clear understanding of the facts is an absolute necessity, for a clear and comprehensive understanding of the facts will dictate the plan of action. The workout officer should make no assumptions about the credit nor should he rely completely upon his predecessor's version of the facts. He must make his own complete investigation of the situation. Otherwise, he may develop a workout plan that blows up because it was predicated on unreliable information and incorrect assumptions.

The correct procedure for investigation revolves around creation of proper files which accurately reflect the credit relationship. In order to create proper files, the workout officer must necessarily

- gather all information from all sources in the bank and outside the bank including all existing credit files, working files, desk files and so forth,
- order or otherwise obtain unbiased information about the collateral and the feasibility of its providing all or part of debt service and ultimate repayment,
- organize this disparate information chronologically within subject matter (i.e., collateral, outside ability to pay),
- eliminate duplicates and organize notes on, scraps of paper,
• analyze the facts the file reflects as it is organized, and
• synthesize the facts into a plan.

Information and analysis obtained or performed by the workout officer which is subject to attorney-client privilege should be segregated.\(^9\) If the workout officer has any doubts or concerns with respect to the nature of the information in the file, its sensitivity in the event of litigation or the applicability of the attorney-client privilege, the bank's counsel should be consulted for advice.

9. The attorney/client privilege generally refers to the client's privilege to refuse to disclose and to prevent other parties from disclosing confidential communications which are made to facilitate the rendition of professional legal services. Communications between the client or the client's representative and the lawyer or the lawyer's representative which are confidential are protected. See United States v. Kovel, 296 F.2d 918 (2d Cir. 1961) (if is necessary that the communication be confidential). Confidentiality requires an intention that the communication not be communicated to third parties. See Dorothy K. Winston & Co. v. Town Heights Development, Inc., 376 F. Supp. 1214 (D.C. Dist. 1974) (the communication must be intended to be confidential). In some states the attorney/client privilege is given a strict construction because of its tendency to suppress the truth, see, e.g., San Francisco v. Superior Court of San Francisco, 37 Cal. 2d 227, rehearing denied, 231 P.2d 26 (1951) (because of its tendency to suppress the truth, attorney/client privilege receives a strict construction), while in other states a more liberal construction is adopted on the theory that a client should be free to discuss all circumstances of a matter with his attorney without fear that his statements will later be used against him. See, e.g., People v. Shapiro, 308 N.Y. 453, 126 N.E. 2d 559 (1955) (court favored a liberal construction on the theory that one consulting a lawyer should be encouraged to communicate all the facts without fear that his statements may possibly be used against him in the future). The privilege belongs to the client, see Radiant Burners, Inc. v. American Gas Ass'n., 320 F.2d 314 (7th Cir. 1963), cert. denied, 375 U.S. 929 (1963), and only the client may waive its right to the privilege, see Baird v. Koerner, 279 F.2d 623 (9th Cir. 1960) (attorney cannot divulge information that was communicated to him in confidence until the protection afforded by the privilege has been properly waived by the client). In order to insure protection of the confidentiality of the relationship between the attorney and client, policies should be adopted which limit the scope of the parties, to whom information is disseminated and who are in attendance at meetings. The attorney work product protects, from the discovery process, the work produced and developed by an attorney, for his client, in anticipation of litigation. The “work product” of an attorney in preparing for litigation includes the mental impressions, conclusions, opinions, and legal theories of the attorney or other representative of a party to the litigation, see Fed. R. Civ. P. 26(b)(3), and is reflected in such things as memoranda, statements, correspondence, interviews and briefs. See Hickman v. Taylor, 329 U.S. 495 (1947). The work product doctrine encourages effective preparation for litigation consistent with the adversarial system, based on the theory that each side should prepare its case independently without unnecessary interference. Id. Particular litigation need not have actually been commenced in order for the doctrine to apply, but there must be some probability that particular litigation will occur. See Diversified Industries, Inc. v. Meredith, 572 F.2d 596 (8th Cir. 1977) en banc (1978). The degree to which specific litigation must be contemplated, and the question of whether the work product doctrine protects documents which were generated other than in the case in which discovery is sought, varies from state to state.
File gathering, organization, culling and written analysis has the important side benefit of demonstrating to internal and external reviewers that workout officer has complete understanding of the credit relationship and a plan to rehabilitate or collect the loan or to realize on the collateral.

2. **Credit file.**

Analysis of a troubled credit relationship is divided into two parts:

a. the borrower’s or guarantors capacity to service and amortize his debt from sources outside the asset(s) financed including the availability of additional collateral or financial support, and

b. the assets’ susceptibility to providing repayment of debt through sale or refinancing.

A properly constructed credit file will contain the information and analysis necessary to determine borrower/guarantor capacity to pay.

The credit file must first be organized by subdividing it into appropriate sections, eliminating duplicate information, identifying and finding missing information and filing each section in chronological order.

As various components of the file are built, the workout officer should study and make reading notes from analytical memos, correspondence, borrower/guarantor financial statements and cash flow with focus on the borrower/guarantors:

- sources of cash,
- required and optional uses of cash,
- unpledged liquid assets such as tradable securities,
- debt to other lenders and their collateral,
- unpledged liquidable assets such as seasoned income producing property, and
- unpledged cash flowing assets such as seasoned notes receivable, available second liens on cash flowing property or, much less desirable, interests in cash flowing partnerships.

Outdated or extraneous information should be noted and properly filed, but no time should be spent on in depth analysis.

Careful study and complete reading notes will facilitate analysis of the borrower/guarantor capacity to service the existing loan or any form of restructured loan.

3. **Project Files.**

The second part of analysis of a troubled credit relationship comes from gaining thorough understanding and knowledge of the assets pledged. This is accomplished through collection, organization and analysis of material necessary to build a project file for each collateral asset.

The workout officer should gather from every source in the bank all information relating to each collateral asset including:

- the original loan underwriting memo,
• draw requests and certifications,
• appraisals and feasibility studies, if any, made in connection with initial underwriting,
• all subsequent appraisals and feasibility studies,
• inspection reports,
• all contracts and closing statements in connection with prior partial releases of for
  sale properties such as buildings, lots or homes,
• rent rolls on income producing collateral,
• all leases and lease summaries on income producing collateral,
• year to date and current month operating statements on income producing collateral,
• copies of service contracts such as janitoring, equipment, etc.,
• copies of all other third-party contracts, if any,
• all environmental studies and assessments, if any,
• all borrowing base reports and aging reports of accounts receivable,
• letters of credits,
• all correspondence to and from the borrower/guarantor(s) relating to the property, and
• all internally generated memoranda describing the property.

The workout officer should request and receive the desk files of his bank predecessor
which files often contain items not found in official files. Any information listed above
which is not in the bank's possession should be requested of the borrower in writing.

Concurrently, the workout officer should order: (i) a title report to identify any
mechanic's or materialman's liens or other claims filed of record on the property; (ii) an ad
valorem tax certificate from all applicable taxing authorities; and (iii) a certificate of insur-
ance from the borrower if not already taxing authorities; and (iv) a UCC search in all
applicable jurisdictions with respect to any personal property collateral. Environmental
issues should be addressed at this point. The project file of each collateral asset should
then be organized in the format outlined in Procedures. Extraneous and duplicate infor-
mation should be discarded unless it contains an original signature.

Finally, the workout officer should order from a competent appraiser an updated
appraisal of the collateral based on current market conditions and the current status of the
collateral. The appraisal should be supplemented by a feasibility study which considers
current market conditions. The appraisal gives guidance in determining correct account-
ting treatment of the loan. The feasibility study gives guidance in development of a plan of
restructure.

As the project file is being constructed, the workout officer should analyze appropriate
documents to give him knowledge of:

• status of completion,
• current market for the product offered,
• waste or mismanagement by the borrower,
• recent sales volume (for sale properties),
• recent leasing activity and current operating costs (income properties),
• current and near term identifiable cash flow produced by the property,
• claims of others on the property, and
• the value and salability of the property.
Again, careful study and complete reading notes will facilitate analysis of the situation.

4. Legal files.

The legal documentation of the loan should be in reasonably good order if closed by the bank's own legal staff or outside counsel. Any missing documentation such as recorded deeds of trust, mortgages, UCC financial statements, paid tax receipts or insurance certificates should be obtained by collateral cage personnel under the workout officer's oversight.

The legal documentation of loans not closed by the bank's attorneys may be incomplete. In such case, collateral cage personnel with the assistance of a paralegal (if necessary) should gather all missing documents, cure filing defects and organize the file.

The workout officer should carefully review the note, guaranties and loan agreement for business points to determine, for example, whether the guaranties are of payment and performance or only of collection, whether the guaranties are limited in any way, whether the construction loan agreement contains a provision requiring a borrower's deposit in certain circumstances and whether all loans are cross collateralized or cross defaulted. These and other points will become important leverage either to the bank or to the borrower in negotiations. The workout officer must know whether he is dealing from strength or weakness. Typical business deficiencies in loan documents include:

- No cross default or cross collateralization;
- No right to approve leases;
- No borrower deposit requirement;
- No time limit on right to cure defaults;
- No penalty interest provision;
- Limitations on exercise of certain remedies;
- Inadequate insurance provisions;
- Inadequate restrictions on sale of personal property; and
- No lock box provisions relating to receivables.

Legal sufficiency of the loan documents should be reviewed by the bank's counsel. After review, counsel should report any significant deficiencies to the workout officer along with required remedial action and a cost estimate therefor.

Loan participations purchased present additional complexity. Often, the lead lender has virtually unlimited decision making powers in a workout effectively foreclosing the bank's legal right to participate meaningfully in negotiations with the debtor. The participation agreement may contain a buy-sell provision under which the bank could take out the lead lender or force being taken out itself, invariably at a loss. However, being taken out at a loss may be less costly than being an unwilling participant in oafish negotiations by an unskilled, or worse, financially weak lead lender. Also, the lead lender may be constrained in debtor negotiations by its obligations to the other participant(s).

Legal leverage and significant documentation deficiencies should be identified and analyzed with the assistance of the bank's counsel.

5. Physical inspection.

Collateral assets should be personally inspected by the workout officer promptly upon
his receipt of the case. The extent and nature of the physical inspection should be made only in accordance with the rights of the bank under the loan documents and applicable law. During inspection, particular attention should be paid to design, quality, maintenance, location, access, traffic, neighborhood ambiance, evidence of competition such as "for lease" and "for sale" signs on surrounding properties and so forth. The workout officer should approach the collateral asset with the view of a tenant or buyer as the case may be. What about the property would encourage or discourage its lease or sale?

During inspection, the workout officer should be alert for signs of obvious construction defects, deferred maintenance or environmental hazards. If he suspects any, professional engineers should be engaged to make a thorough investigation and written report immediately.

6. **Environmental issues.**

Case law under the federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA")\(^1\) and comparable state statutes is developing toward the perceived deep pockets of lenders. For example, in *U.S. v. Fleet Factors Corp.*\(^2\) the 11th Circuit Court of Appeals found that a secured lender may incur liability under CERCLA merely by participating in the financial management of a facility to a degree which would indicate that it had the capacity to influence the borrower's treatment and disposal of hazardous waste.

Thus, it is incumbent on the workout officer to become thoroughly knowledgeable of environmental procedures and pitfalls and to be aware of circumstances which could expose the bank to unlimited claims under environmental laws.

7. **Special issues in construction loans.**

It is often in the bank's best interest to retain the debtor's interest and cooperation at least through completion of construction since, if he is honest he can usually complete the project faster and cheaper. If the bank has lost confidence or the debtor has given up, the following issues must be addressed if the bank intends to complete the project.

- Contractor and subcontractor status.
- Legal access to plans and specifications in absence of debtor.
- Subcontractor liens and lien waivers.
- Defenses to mechanics liens.
- New permits in name of bank.
- Cost of construction delays.
- Feasibility of restriction of project scope.
- Preservation of payment and performance bonds.

B. **THE DECISION: WORKOUT OR FORECLOSURE?**

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X. Concluding Observations.

This paper explores the circumstances facing debtors and creditors in America in the grip of a national crisis of capital inadequacy. Although America had faced a relatively recent banking crisis in the mid-1970's, it paled in comparison to the recent distress. Loan underwriting became irrelevant. The absolute loss in value of many assets which served as collateral for bank loans was systemic and unavoidable by the debtors and creditors. This systemic loss is distinguished from the "systemic" banking crises alluded to by many commentators as the risk of one bank's failure to the solvency of other banks in the banking system. Although the systemic crisis of capital adequacy in America did, in fact, pose bank-to-bank system risks, the issues presented were far more fundamental to overall American financial stability and bank solvency.

The American systemic crisis of capital adequacy was manifest where capital reposes, in assets; assets which collateralize loans, and which comprise the asset side of a banks' balance sheet, and which are the source of a bank's solvency and liquidity. Although the American crisis has been characterized as the consequence of regulatory and supervisory failure and management abuse, while true in part, such a characterization obscures and begs the more fundamental questions regarding the source of the systemic problem and encourages a localized "micro" response from government regulators, supervisors, examiners and bank managers.

This paper focuses on the "micro" manifestations to the problem, and outlines a small part of the context of the problem in America. Debtors and creditors as well as regulators in other jurisdictions such as Mexico, Latin America, Central and Eastern Europe and even Japan, who continue to categorize their banking and credit "problem" as local and explainable by focusing blame and recrimination on obvious participants in an echo of the early foundations of insolvency law, must accept that the problems are not limited to America.

The world wide systemic problem of capital adequacy and bank insolvency is not, fundamentally, a problem of bank mismanagement, fraud or crime, but represents a broad-based world-wide systemic problem of capital adequacy, whose roots predate the recent American crisis, and which has spread throughout both so-called "developed economies" as well as emerging and transitional economies. As international pressure for "transparency" in financial information disclosures as well as consistency and clarity in accounting rules and laws relating to banking, credit and security creation and enforcement increase, borrowers, bankers, accountants and lawyers in emerging economies will find the principles and strategies presented in this paper to be of increasing relevance and importance. Attention to the principles, practical issues and strategies presented in this paper will be of benefit to debtors and creditors in other jurisdictions who now face the consequences of the global crisis of capital inadequacy.