



**SMALL BUSINESS  
INVESTOR ALLIANCE**  
LUNCH & LEARN WEBINAR SERIES

# Managing Credit in a Downturn

## September 15, 2020



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## SBIA Lunch & Learn Webinar Series: Managing Credit in a Downturn

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# Managing Credit in a Downturn



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- Amendment, Loan Modification and Extension
- Forbearance Agreement
- Turnaround Consultant
- Assignment of Note and Collateral Documents
- Asset Sale by Borrower
- Article 9 UCC Sale
  - COVID affects “commercial reasonableness”
- Deed In Lieu of Foreclosure
- Receiver/Assignment for the Benefit of Creditors
- Litigation/Foreclosure Action



## ■ Initial Steps

- Own document review for rights and status as secured creditor; update lien searches
- Analyze capital structure: relationship with other debt and equity holders
- Collateral valuation: update appraisals, commercial finance exam
- Determine negotiating group: workout team vs. relationship officer

## ■ Workout Agreements

- Reservation of Rights Letter / Default Letter / Limited Waiver
- Amendment to Loan Agreement
- Forbearance Agreement
- Restructuring Agreement
- Intercreditor Agreement

## ■ Key terms

- Amendments – additional interest (PIK?), fees, covenants, collateral, guaranties
- Time frame – Amend and Extend / Forbearance Period / Milestone Dates
- Forbearance Conditions and Covenants
  - Revised payment schedule
  - Additional financial reporting – 13-week cash projections; weekly liquidity reporting
  - Turn-around advisor
  - Management changes
  - Investment banker for potential sale
  - Refinancing and sale milestones
- Waiver of defenses and counterclaims; Releases

- Cost of Money Considerations (107.855)
  - General Rule: Cost of Money ceiling of 19% for a Loan and 14% for a Debt Security
  - You can exclude from the Cost of Money the difference between the contractual interest rate of the financing and a default rate of interest
    - If a Small Business is in default, you may charge a default rate of interest as much as 7 percentage points higher than the contractual rate until the default is cured
    - Default interest not permitted for any default
    - For purpose of SBIC regulations, “default” means either failure to pay an amount when due or failure to provide information required under the Financing documents

## Debtor Protections

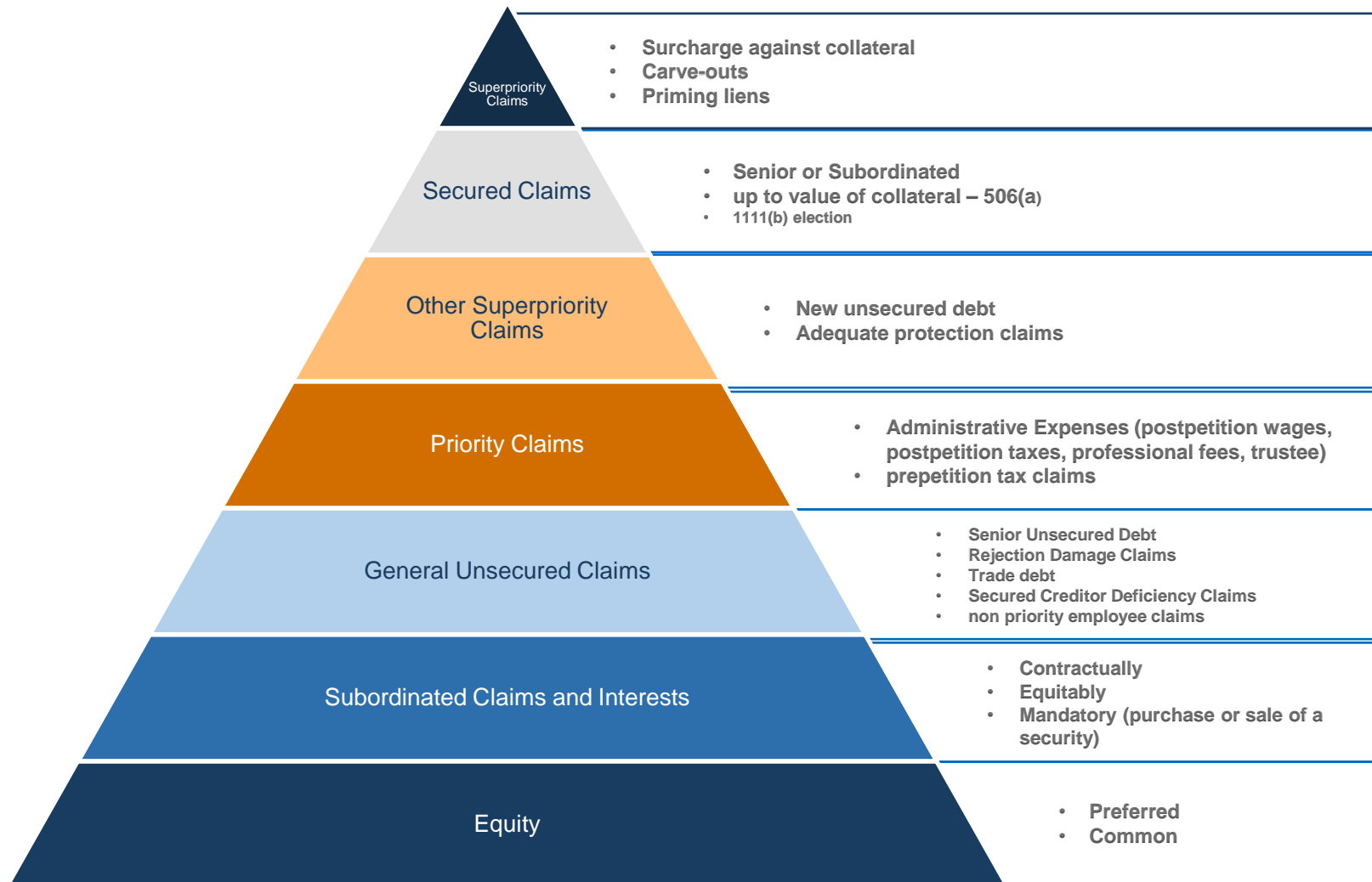
- Automatic Stay
- Debtor's management continues to operate the business in the ordinary course (unless trustee appointed)
- Debtor has exclusive right to prepare a plan (for a while)
- Debtor can assume or reject contracts
- Challenges to Secured Debt/ Lender Liability



## Creditor Rights

- Adequate Protection
- DIP Lender has tight control over spending
- Substantial court and Creditor Committee oversight and onerous disclosure requirements
- Post-petition expenses must be kept current
- Credit Bidding





- Use of Cash Collateral
  - Consent of the secured party or authorization by the court required; secured party must be **adequately protected** (e.g., cash payments, replacement liens)
    - compensated for any diminution in value
- DIP Financing – court authorization needed
  - More typical than Cash Collateral Use
  - DIP Financing usually is secured by all assets of the debtor
    - existing lender must consent or be adequately protected from diminution in value of collateral
  - DIPs can be used offensively (as a takeover device) and defensively (to protect existing collateral position)
  - Proposed DIPs can be subject to competition

- Notifying SBA about Bankruptcy Proceedings (107.660(c))
- General rule is that when you become a party to litigation or other proceedings, you must give SBA a report within 30 days that describes the proceedings and identifies the other parties involved and your relationship to them
- However, notification requirement does not apply to collection actions or proceedings to enforce your ordinary creditors' rights
- Best practice is to keep your analyst informed of the process and any proceedings

## ■ Intercreditor Agreements

- Defines lien subordination and payment subordination
- Establishes rights and remedies amongst the loan parties upon a bankruptcy
- Bankruptcy Code S. 510 requires court to enforce subordination agreements

## ■ Key Terms

- DIP financing (Cap)
- Use of cash collateral
- Adequate protection
- Asset sale
- Voting

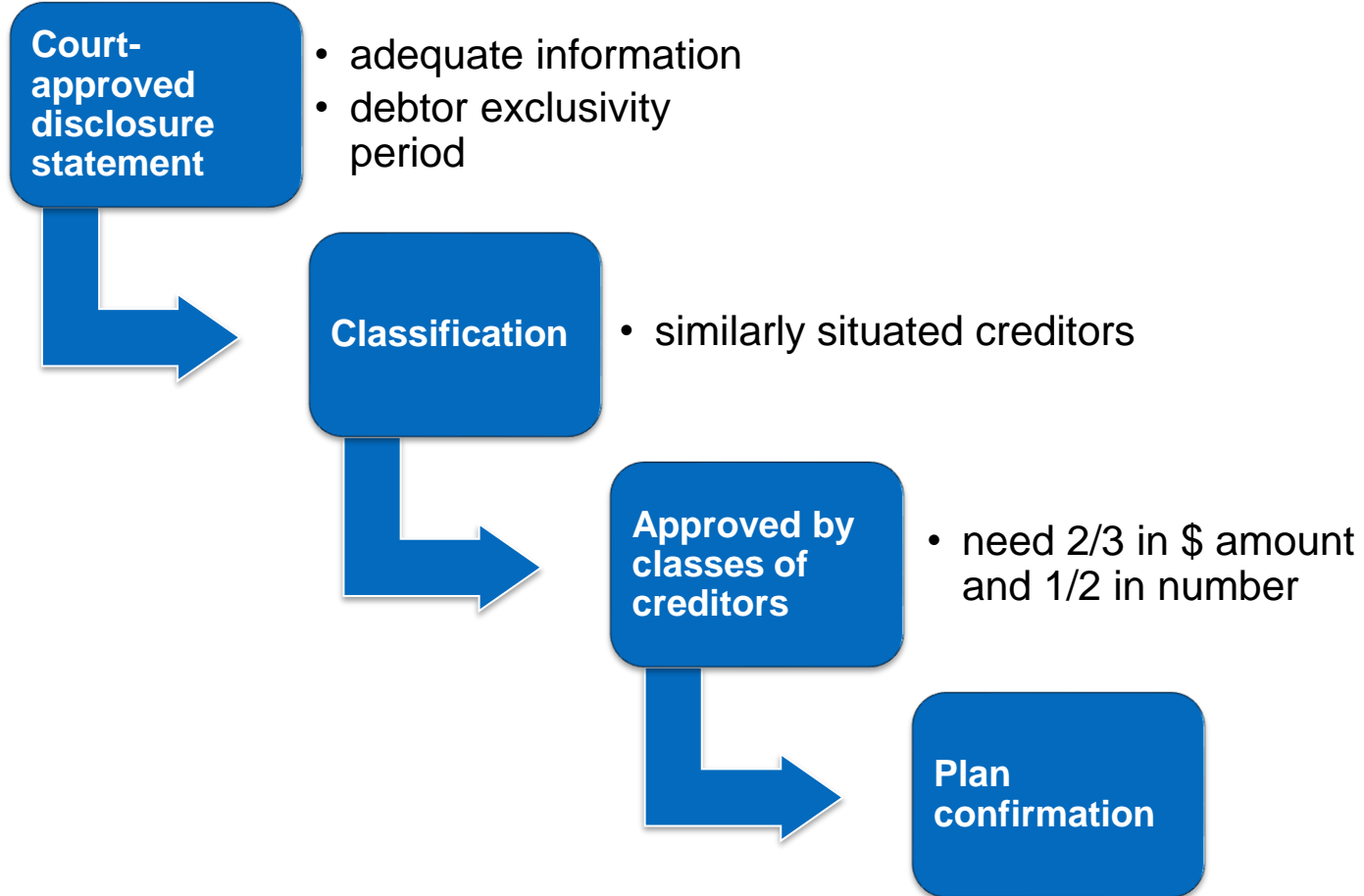
- **Modifying or eliminating junior creditor's right to:**
  - Object to, propose or consent to DIP financing or use of cash collateral
    - Deemed consent to use of collateral; Cannot prime senior lender
      - Negotiated cap on senior debt limits size of priming DIP financing
  - Seek adequate protection (if over-secured)
    - Juniors typically waive right to adequate protection
  - Seek relief from the automatic stay
    - Waive right to seek stay relief or object to senior's request for stay relief
  - Challenge senior creditor's lien
- **Courts uphold junior's right to object as an unsecured creditor**
- **Post-petition interest – stops as of the filing date unless creditor is oversecured or all creditors paid in full**

- Objecting to Section 363 Sale
  - 1st Lien / 2nd Lien – 2nd lienholder waives right to challenge sale where 1st agrees. 2nd lien attaches to sale proceeds consistent with priority within intercreditor agreement
- Junior may preserve right to object in capacity as unsecured creditor
  - Expressly drafted
- Credit Bidding - junior may be allowed to credit bid if senior is paid in full in cash

- Acquisition of assets in full or partial liquidation of a portfolio company's obligation to SBIC (107.880)
- Permitted under provisions of regulations and can be acquired from the borrower entity or a guarantor
  - Must be done within a “reasonable” period of time
  - Reasonably necessary expenditures permitted (i) to maintain and preserve assets acquired, (ii) for improvements to render such assets saleable, (iii) to make payments of mortgage principal and interest (including amounts in arrears when you acquired the asset), pay taxes when due, and pay for necessary insurance coverage
- If you have outstanding leverage, prior SBA approval required if expenses plus financings exceeds overline limit or exceeds 35% of Regulatory Capital

- Disposition of assets acquired in liquidation may required prior approval from SBA (107.885)
- Prior approval required to dispose of assets (including assets acquired in liquidation) to any Associate if you have outstanding Leverage
- Need to demonstrate that the proposed terms of disposal are at least as favorable to you as the terms obtainable elsewhere





- “Cram-down” of the plan over a dissenting class
  - Plan cannot unfairly discriminate
    - August 26, 2020 Third Cir. Tribune decision upheld cram down where plan did not fully enforce subordination agreements: cram down provision of Bankruptcy Code supplants strict enforcement of subordination agreements; look at materiality of the difference in recoveries in the absence of enforcement of the subordination agreement
- “Cram up” - secured debt is restructured without the consent of the secured creditor by repaying the debt in full over time, possibly with other modifications to the debt instrument.
  - reinstatement of the secured debt; or
  - providing the secured creditor with the indubitable equivalent of its secured claim

- Small Business Reorganization Act (SBRA) - subchapter 5 of Chapter 11 of the Bankruptcy Code (11 U.S.C. § § 1181-1195); effective February 19, 2020.
  - Applies to Debtors with non-contingent, liquidated debts of \$2,725,625 or less but Cares Act modified the amount to \$7.5 million for cases filed on or within one year after March 27, 2020 (after March 27, 2021 original debt amount applies).
- SBRA cases
  - Debtor remains in possession and a trustee is appointed; no Committee unless ordered by Court
  - No disclosure Statement is required; only debtor can propose a plan; and Debtor must file plan within 90 days
  - administrative claims may be paid over 3-5 years as opposed to on effective date of plan.
  - Absolute Priority Rule not followed
  - No quarterly UST fees

- PPP Loans may be eligible for forgiveness if proceeds are spent on eligible expenses
  - Payroll, rent, utilities, etc.
- Unforgiven expenses continue as a loan with a 1% interest rate with either a 2 or 5 year maturity
- PPP loan application disqualifies debtors from participating
  - Various court cases sought to enjoin the SBA from enforcing the application's bar of debtors based on section 525 of the Bankruptcy Code and the absence of statutory authority; interim rules subsequently were issued barring debtors; some debtors dismissed their cases, received the loans and refiled.
- Debtors who received PPP loans prepetition would treat the loans as unsecured claims.
- If the Debtors were able to receive loans post-petition, then the loans would be entitled to an administrative expense priority claim
- SBA and Lender must consent to a change in control if a PPP loan is outstanding. Failure to obtain consent would be a breach of the PPP loan terms and SBA's policy and could put forgiveness at risk.



**Questions?**

# Contact Us



If you would like to discuss the foregoing, please contact the following members of our SBIC, Debt Finance, and Bankruptcy & Restructuring practices or any other member of the firm



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Presented by: CohnReznick

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