



**SALES OF SENIOR SECURED NOTES AS A  
BANKRUPTCY ALTERNATIVE**

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## **Sales of Senior Secured Notes As a Bankruptcy Alternative**

With the high costs and time delays inherent in a bankruptcy case, lenders may consider a discounted sale of the notes they are holding (which are deemed as “assets” on the books of a lender) to resolve the repayment of the outstanding debt. This practice is most efficient where: (i) there are few unsecured creditors, (ii) the collateral is somewhat easily valued (e.g., real estate developments), (iii) there is no collateral equity for the borrower to preserve, and (iv) the lender is reluctant to take the collateral on to its books directly via foreclosure. To determine whether or not this technique is attractive in a specific situation, lenders generally gauge the immediate discounted return on their asset against a potential higher return at a later date minus the time delay, legal expense and carry costs of the collateral. Regulated lenders also may need to establish reserves for troubled assets, which also add to the cost factor in valuing a delayed return for the asset. This material discusses the issues and action steps that arise during a sales transaction of senior secured notes.

**I. Initial Steps** – What are the initial steps a potential purchaser and seller take in connection with a loan sale?

A. Purchaser Steps – The steps a potential purchaser takes are dependent on available capital and sophistication. The more sophisticated purchasers may undertake some initial due diligence regarding the target (e.g., site visits, environmental reports, talking with the target, feasibility studies, etc.). Expert investors in the industry or competitors may already be aware of the target and its general value. In fact, the target may already be in bankruptcy or the subject of a foreclosure action, so that a fair amount of information is publicly available. The purchaser may also form a shell company to serve as the direct purchaser – to limit its direct liability to the borrower.

B. Seller Steps – Many lenders are bound by a confidentiality standard under Federal or State law, such that they cannot disclose most aspects of their relationships with their customers. So, initially, sellers will not offer much information. Many sellers will require a prospective purchaser to sign a Confidentiality Agreement (form attached) before talking to a prospective purchaser.

C. Initial Disclosures -- After receiving a signed Confidentiality Agreement, the Seller may be willing to share its loan documentation, publicly available records and certain reports it received (e.g., title reports, environmental reports) in connection with the initial loan. Sellers are not obligated to share those reports – the prospective purchaser can generate some of those reports on its own – and if the purchaser is authorized to share those reports with third parties, the purchaser generally is required to sign a release agreement, acknowledging that the purchaser is not relying on its contents. A seller almost never shares an appraisal with a prospective purchaser, even under a Confidentiality Agreement.

## II. The Letter of Intent –

A. The letters/agreements can take many forms and may be binding or non-binding, depending on the prospective purchaser, the nature of the deal and the additional due diligence to be performed. Predominantly, the first letter of intent in a transaction is non-binding and only expresses the prospective purchaser's interest in buying the loan and loan documents and the preliminary terms of the purchase. Many times (but not always) the letter of intent includes a proposed price, however, sometimes the price is set forth as a formula (e.g., 75% of appraised value of the collateral, based on the purchaser's appraisal, to be conducted).

B. One of the major issues negotiated in a letter of intent is the deposit. In order for the seller to consider a purchase offer as "real", the seller may require the prospective purchaser to post a substantial deposit. The amount and binding nature of the deposit are always the subject of negotiation and leverage.

C. Another major letter of intent issue involves the exclusivity of the proposed bid. Many prospective purchasers are not interested in spending due diligence monies unless they know that they will not be bidding against other prospective purchasers, so they require an exclusivity period (i.e., marketing prohibition) during the due diligence period. Sellers may agree to such a provision in exchange for a binding or "hard" deposit.

## III. Competing Bidders –

A. How does one deal with competing bidders for the same asset? A few items to consider:

- i. Weeding out speculating bidders. Setting initial bidding requirements may force bidders with insufficient capital or unsure interests to withdraw their bids. Initial bidding requirements could include either a large deposit or proof of cash for final payment, prior to accepting a letter of intent.
  - ii. Bidding can be held by public auction or by private written bids. Bidding procedures must be clearly described before bids are accepted, so that there is no dispute as to the choice of the successful bidder.
  - iii. Use of a professional auction firm or brokerage firm may lessen risk of disputes over choice of the successful bid.
  - iv. Use of a stalking horse bidder for a particular loan can act in a similar manner to using a stalking horse at a 363 bankruptcy sale to obtain the highest and best bid for the loan.
- B. Dealing with insider bidders. When one bidder is an insider (e.g., guarantor, subordinated creditor, competitor of the borrower), great care must be taken to avoid claims of insider favoritism. Third party bidders may also be reluctant to bid against

a bidder with inside information, As a result, the seller may choose not to sell to an insider if other bidders are available.

**IV. Selling to Buyers with Insider Information Generally --**

- A. When considering a sale to an insider when other insiders either may be interested bidders or may make claims of favoritism against the seller, the seller must take steps to insulate itself from those claims.
- B. Steps to Consider: Giving prior notice to all obligors and insiders of a pending sale and a pre-sale opportunity to bid or to pay off the loan prior to the sale date. The seller may also seek to obtain waivers and releases from all obligors to regarding the sale or the threat of a sale may force an overall workout of the credit, out of a concern that a competitor might use the sale to take over the borrower.

**V. Documentation Issues --** The following issues are generally the subject of discussion in the documentation of a loan sale:

A. Representations and Warranties of the Seller – many financial institution sellers will only offer scant reps and warranties to lessen liability and to create less of a due diligence burden to get to closing. Typical reps and warranties that are controversial include:

- i. Lien position on collateral
- ii. Claims made or threatened by the borrower/guarantors
- iii. Loan documentation deficiencies
- iv. Issues affecting collectability of the loan

B. Buyback requirement on certain terms and conditions – will the seller agree to buy back the loan if certain conditions existing at the time of sale? Generally, if the reps and warranties are incorrect, such that the loan is uncollectable, then the buyer has a damages claim.

C. Indemnity of buyer for seller acts/indemnity of seller for buyer acts

D. Price Adjustments based on incorrect reps/warranties

E. Lost Documentation – if the note is lost (not uncommon in large merged institutions), the seller may offer the buyer a Lost Note Indemnity (form attached) to cover the potential inability to deliver an original note.

F. Limitation on Remedies for Failure to Close.

G. Servicing of the Loan – the Agreement will describe the limitation on the Seller in servicing the loan after signature on the Assignment document and before closing (if there is a gap period). In addition, if the seller will continue to service the loan post-closing, separate servicing provisions or a separate servicing agreement may be required.

**VI. Closing Issues –**

A. Once the documentation is fully executed and funds delivered, the seller then must endorse the note (either by allonge or on the reverse side of the original signature page) in favor of the buyer. A typical endorsement may appear as follows:

**PAY TO THE ORDER OF [name of purchaser] WITHOUT WARRANTY,  
REPRESENTATION OR RECOURSE OF ANY KIND:**

**[name of seller]**

**By: \_\_\_\_\_  
Name:**

B. Once the note is endorsed, the seller delivers the entire set of original loan documents to the buyer for their use.

C. Post-closing items. The buyer may also require the seller to execute mortgage assignments, UCC financing statement assignment or substitution of parties in pending litigation, in favor of the buyer. Failure to have these documents signed at or just after closing may complicate the buyer's actions with or against the borrower going forward and may complicate the seller's position long into the future, if the buyer neglects to remove the unassigned mortgage when the loan is finally paid off.

**VII. Loan Purchasing as a Method to Bolster a Foreclosure Sale Bid –** Once the loan is purchased, the buyer merely steps into the shoes of the originating lender. The buyer gets the benefit of interest payments and a lien position, but does not ultimately own the underlying property. Loan buyers may use the purchase of the loan as an intermediate step toward owning the underlying collateral, either through foreclosure or through consensual agreement with the borrower. A properly conducted foreclosure will wipe out any subsequent lien holders on the property and may be a preferred means of obtaining ownership.

A. Loan Purchase to Obtain Better Information about the Borrower – by conducting due diligence subject to a confidentiality agreement, the loan buyer sees information about the property being foreclosed upon, the borrower's business and financial condition and the lender's claims well before a normal foreclosure bidder.

B. Loan Purchase to Enhance Bidding Ability – by purchasing the foreclosing creditor's claim, the purchaser has the ability to credit bid (*i.e.*, bid up to the debt amount owed to the creditor) on the foreclosed property in excess of the amount actually paid for the loan. If the buyer bought the loan at a discount from par (*i.e.*, presumably at or near the value of the property being foreclosed upon), then the buyer's bid up to the full amount owed will easily surpass any other bids for the property.

C. Loan Purchase to Avoid Transfer Tax – in some states, delivery of a sheriff’s deed to the foreclosing mortgagee as a result of foreclosure is exempt from transfer tax. By purchasing the loan prior to foreclosure, the buyer obtains the benefit of status of foreclosing mortgagee and saves the lender from taking the property on to its books first.

**VIII. Loan Purchase as a Method to Manage Cancellation of Indebtedness Income --**

A. When a creditor agrees to discount the principal amount owing under a loan by more than \$600 as an overall settlement with a borrower, the amount of the discount may constitute cancellation of indebtedness income (“COI”) which is taxable to the borrower. Creditors offering COI must report the COI amount on IRS Form 1099 on an annual basis and the failure to report COI income may leave the creditor subject to a penalty.

B. Borrowers seeking to reduce the effects of COI may choose to form a shell entity to be the purchaser of the loan from the lender at the agreed upon discounted amount. The purchaser would now hold the loan at the full value of the loan without discount and the originating creditor has received the benefit of the discount bargain.

C. While the purchase does not eliminate COI, it does allow the purchasing creditor to spread out the loan payments and the discount over many taxable periods so that the COI tax bite in any particular period is minimized.