

Preparing for a "Looming" Recession: Practical Tips for Lenders

Part One of a Three-Part Series

By: Nancy Sabol Frantz and James Vandermark

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The word "looming" seems to have become very popular during the past several years within the context of describing potential commercial credit maturities and defaults and, more recently, a potential recession. "Looming" may be a bit overused, but its prevalence in economic news can give the commercial lending industry an opportunity to prepare for worst case scenarios. If a credit default is anticipated, is your credit origination team well versed in the pitfalls of "extend and pretend" or workout communications? If not, perhaps a tutorial about pre-negotiation agreements, and the need to consult with in-house and/or outside counsel, is in order.

WHAT IS A PRE-NEGOTIATION AGREEMENT?

A Pre-Negotiation Agreement (PNA) is a contract which establishes certain guidelines and protections with respect to communications between lenders and debtors regarding a potential modification or restructure of an existing financing which is either in default or is anticipated to be in default. The goal of a PNA is to clearly establish that communications regarding the distressed debt are "settlement discussions" or "offers of compromise" and therefore, not admissible as evidence under applicable rules of evidence.

WHAT ARE THE KEY TERMS AND CONDITIONS OF A PNA?

A PNA, at a minimum, should contain the following provisions:

- That the communications are intended as an opportunity for the parties to consider possible terms for restructuring, modification, extension, or other resolution of the credit facility, and any related refinancing, sale, or other disposition of the collateral, and to determine appropriate ways to resolve credit facility related matters in accordance with any such terms finally agreed to by all parties.
- That there is no assurance that agreements can be reached on any or all of the issues, and that no compromise, offer of compromise, settlement, agreement, or understanding among any of the parties concerning any of such matters will be effective or binding for any purpose unless and until it is included in a fully-executed "Definitive Agreement."
- That no party will have any liability whatsoever for any failure to reach agreement on any of such matters or any other matters the parties may address in the discussions.
- That no party will have any obligation to continue participating in the discussions, and each party, in such party's sole and absolute discretion, may withdraw from and cease its involvement in the discussions at any time, for any reason or no reason, with or without cause or notice and without liability for doing so.
- That the discussions and all communications between the lender and the borrower parties are confidential (unless waived by the lender), constitute settlement negotiations, and all information received may be used solely for the purpose of facilitating a settlement, will be protected accordingly, may not be used for any other purpose whatsoever (including as proof of any admission of liability or for any other evidentiary purpose), and will not be admissible as evidence or subject to discovery with respect to any issue that is or may be before any court or administrative body or the subject of any other proceeding.

- That the borrower and all guarantors affirm that the loan documents remain in full force and effect, acknowledge the existing default(s), confirm that no other defaults exist and represent that they have no defenses or causes of action against the lender.
- That neither the execution of the PNA nor the conduct of the discussions or any communications shall in any way be deemed or construed to rescind or cure any existing default, reinstate the credit facility to a current status, constitute an accord and satisfaction, indicate or establish any course of dealing, modify the loan documents or the maturity or any other terms of the credit facility, modify the legal relationship among any of the parties, constitute a financial accommodation of any kind by lender in favor of any loan party or create any commitment or obligation on the lender's part to make any such financial accommodation at any time, constitute a waiver or release of, or require any forbearance by lender with respect to, any available remedies, or create any new obligation on the part of any party.

What are the possible consequences of Not Having a PNA?

If a loan workout is not effectuated by a so called "Definitive Agreement," the purpose of the PNA is to prevent the ability of a debtor (or guarantors) to have evidence admitted in a lender liability or other action supporting a claim that the lender is bound by any terms sheets, drafts of documents, conversations or e-mails (or perhaps even text messages) and that an agreement was reached on one or more of the discussed terms, although a definitive written agreement was not executed.

Although decided years ago, the decision of the court in *Busy Bee, Inc. v. Wachovia Bank, N.A.*^[1] is an excellent, albeit lengthy, illustration of the ability of a debtor to introduce evidence of communications and actions of a lender in order to prevail in a lender liability action. In *Busy Bee*, the plaintiffs/debtors were awarded \$10.3 million in compensatory damages and \$7 million in punitive damages in a lender liability action against Wachovia Bank. The plaintiff/debtor alleged breach of express and implied duties, breach of fiduciary duty, fraudulent misrepresentation and negligent misrepresentation. Specifically, the plaintiff claimed, *inter alia*, that: (i) the bank's wrongful conduct during its post-declaration of default negotiations prevented the borrower from obtaining alternate financing and eventually drove it into bankruptcy and (ii) the bank "strung along" the debtor during post-default negotiations by exchanging drafts of agreements with terms that differed from verbal agreements allegedly reached. When reviewing the decision, one wonders how the debtor could have established its claims at all had a PNA existed. *Busy Bee* is worth reading so you may reference it if a lender/client protests against the use of a PNA.

It is important to note that, although in general, rules of evidence bar admission of most evidence of settlements, they do not bar all such evidence. The decision of the United States District Court for the Southern District of New York in *In re Vargas Realty Enterprises, Inc.*^[2] allowed a PNA to be admitted as evidence because it was being offered for "another purpose." That purpose was to evidence the borrower's intent to ratify the underlying note and mortgage, rather than as proof of contents of any offer to settle. An important distinguishing fact in the *Vargas* case was that the PNA itself clearly stated that it could be admitted into evidence. Usually a PNA is not intended to be admissible, however, in this case the debtors were disputing whether the loan documents were valid and the PNA was intended to ratify the loan documents.

PRACTICAL TIPS

If involved in a distressed debt matter, it is important to understand the utility and importance of a PNA. It is also critical to be familiar with the applicable rules of evidence governing admissibility of settlement discussions or offers of compromise in the applicable jurisdiction, and if necessary, involve both a transactional and a litigation attorney in the preparation of a PNA.

Stay tuned for Part Two of this series: Who is Essential to Your Workout Team? In the meantime, if you have questions or would like further information, please contact Nancy Sabol Frantz (frantzn@whiteandwilliams.com; 215.864.7026) or James Vandermark (vandermarkj@whiteandwilliams.com; 646.837.5791).

[1] *Busy Bee, Inc. v. Wachovia Bank, N.A.*, 2006 WL 723487 (Pa. Com. Pl. Feb. 28, 2006).

[2] *In re Vargas Realty Enterprises, Inc.*, 440 B.R. 224 (S.D.N.Y. 2010).

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.