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THE DISTRESSED REAL ESTATE BORROWER IN ROMANIA: WHAT IT COULD EXPECT FROM BANKS AND WHAT IT CAN DO ABOUT IT

A. INTRODUCTION

There are better positions to be in than a real estate developer having borrowed heavily from banks to develop their projects in Romania. Real estate borrowers enjoyed the boom times of Romanian real estate between 2006 and 2008 when banks liberally gave financing for their real estate projects on advantageous terms. Prices kept climbing and investors kept coming and gobbling up projects at high prices. Generally, those were happy times.

But with the US sub-prime crisis as the catalyst, this dream has turned into the proverbial nightmare. In 2009, banks in Romania have essentially stopped lending. The lack of financing has caused a series of "knock-on" effects: falling prices, lack of demand and a general shake-up of the real estate market that has skewered borrower's financial models. And to date, there seems to be little light at the end of the tunnel.

So instead of enjoying their cognac and cigar as they watch their bank accounts overflow, real estate borrowers have almost overnight been thrown into a distressed situation and trying to think of measures to safeguard their real estate asset and their reputation. In parallel, banks to date have adopted a "wait-and-see" approach in order to avoid potentially crippling and embarrassing write-offs of their assets in their books.

But most market participants and observers agree that "something has to happen" with the banks' bad loans and that the number of foreclosures is expected to increase.

The point of this article is to consider the typical real estate borrower who gave the bank: (i) a first-rank mortgage on a property; and (ii) a pledge on the borrower's shares. The real estate borrower is in arrears on its repayment obligations and does not have resources to meet them – meaning that it is in default under the loan documentation.

In these circumstances, what is the foreclosure procedure? How long does it take? And what can the borrower do about it?

These are typical questions we have received on numerous occasions from distressed and stressed-out real estate borrowers. Below we try to answer them in a clear manner.

B. MORTGAGE FORECLOSURES – HOW FAST?

1. Bank Notification

When a borrower whose loan is guaranteed by a real estate asset falls into repayment arrears, the first step normally taken by the bank is to notify the borrower by recorded delivery or via a court bailiff (Romanian: *executor judecătoresc* – the “**Bailiff**”).¹ Normally, this notice will state that the borrower is in default and has a certain number of days to cure the situation. If the borrower does not respond to this notification, or fails to respond in a manner that satisfies the bank, the bank is free to accelerate the loan, opening up the way for foreclosure of the loan guarantee.

2. Bailiff Notification

Assuming the borrower does not respond to the notice above, the bank then calls in a Bailiff to begin foreclosure. The Bailiff will approve the foreclosure with the court by forwarding a formal foreclosure request, as well as the executory title. This is a formality which takes no more than three to five (3-5) days.

After this step, it will go to the actual location of the asset subject to mortgage in order to compile a ‘location protocol’ (Romanian: *Proces-verbal de situatie*), which essentially describes the status of the asset. Thereafter, it issues a summons to the borrower explaining to it that unless it honors its repayment obligations, the asset underlying the mortgage will be put up for sale. The summons is sent by registered mail, with return receipt, to the borrower’s notification address in the mortgage documentation or its registered headquarters. At the same time, the Bailiff also informs the borrower that the summons had been registered by the Bailiff with the property’s land book.

We note at this point that within ten (10) calendar days after it received the summons, the borrower may ask the court to allow a six (6)-month delay, but only if it proves that all due amounts and interest accrued thereto might be paid from the asset’s rental income.

3. Proceeding to Auction

If the borrower does not pay all due amounts within fifteen (15) calendar days of being summoned to do so (and it was not allowed or it has not applied for the six (6)-month delay mentioned above), the Bailiff values the asset, either by asking the parties involved to agree a price or on the basis of an opinion of an independent and ANEVAR-qualified¹ appraiser appointed by the Bailiff, and proceeds with its sale by auction. The Bailiff will usually announce the auction to the press (publication of wide circulation) within five (5) calendar days of valuing

¹ In Romania, the bailiff is a court public service provider, acting in a private capacity but conducting activities related to enforcement of court decisions. Their activity is governed by statute.

¹ Romanian Valuers’ Association, established in 1992 as a private professional association, recognized as a public interest association in 2004, governed by its own statute.

the asset. The auction itself will take place inside a thirty (30) calendar day window which begins thirty (30) calendar days after knowledge of the auction being made public.

The auction is held at the Bailiff's office, or at the foreclosure court hearing, or at the asset's location, or wherever is deemed suitable and set forth in the announcement. Would-be participants in the auction are required to post a surety with the Bailiff amounting to 10% of the starting price.

At the auction, the Bailiff offers the asset for sale by three (3) shouts, starting with the bid larger than the established price of the asset. If this price is not met, the sale is to be postponed by sixty (60) calendar days, after which the price is lowered to 75% of the originally established value. If unsold, the asset is sold to the highest bidder.

Once the auction is finished, the Bailiff drafts a summary protocol, and the winner is declared. The auction winner is obliged to pay the Bailiff within thirty (30) calendar days of the sale date. Failure to meet this deadline will lead to the asset being put up for sale again, at the Bailiff's expense.

Upon full payment of the sale price, or of the first due amount if the price is to be paid in installments, the Bailiff will draft a deed stating the outcome of the auction. A copy of it will be given to the auction winner to serve as title over the asset, enabling it to register the asset in the competent land registry. Registration with the land registry will occur automatically free of mortgages or other encumbrances.

4. How Long Does This All Take?

Knowing all of this, how long does the borrower have before it finds its asset sold? If the Bailiff follows the procedure to the letter and it makes a conscious and expedited effort, in principle, it could finish within approximately six (6) to eight (8) weeks of a bank's decision to foreclose. However, this is normally unrealistic given the workload of Bailiffs and other intervening factors, generally meaning **a more realistic timeline of five (5) to seven (7) months from the beginning of foreclosure procedures to final sale of the asset.**

C. FORECLOSURE ON PLEDGE ON SHARES

So for whatever it may be worth, the borrower does have some time at its disposal before the bank can foreclose on an asset. But the bank normally also has a pledge on the shares of the company owning the asset. Does this process go any faster for the bank? Pledge foreclosures are actually a relatively untrodden pasture in Romania, and we explore the same set of questions below.

1. Is a Pledge on Shares Really Enforceable? Practical Hurdles

In the case of a limited liability company (SRL) having more than one shareholder, there is a practical problem caused by inconsistencies in applicable legislation. Law 99/1999 *regarding Measures for the Acceleration of Economic Reforms* ("**Law 99/1999**") stipulates two ways of enforcing: either by enforced sale to a third party or by direct adjudication by a creditor. In either case the consequence is practically the same: the borrower loses its ownership right over the shares, which means the loss of its status as shareholder of the limited liability company.

This would be no problem, but for an essential detail of Law 31/1990 *regarding Commercial Companies* (“**Law 31/1990**”), on the incorporation and functioning of limited liability companies: that shares can only be transferred outside the company with the consent of those shareholders owning at least 3/4 of the social capital.

This means that if the SRL has more than one shareholder, the bank cannot foreclose on the shares unless it has express agreement of those shareholders of at least three quarters (3/4) of the share capital. Furthermore, the irrevocable and unconditional express agreement of all the shareholders is a condition to enforce through a sale to third parties or direct adjudication. Consequently, banks normally request the shareholders to agree in advance to any type of enforcement by the bank in case the borrower would default.

But the foreclosing bank still faces an administrative setback. Shareholding of a company is not legally dependent on the trade registry. Nonetheless for SRL's it is preferable for registration to occur, particularly in relation to third parties and any potential buyer of the shares, who will always require registration. Because changing a shareholder constitutes an amendment to the articles of incorporation according to law, the registration of the bank as a new shareholder of the company in the trade registry will also require a deed of amendment to the articles of incorporation. This document, regardless of form (i.e., a decision of the shareholders or amendment to the articles of incorporation) will most likely require the signatures of the other shareholders, including the borrower. This is a trade registry requirement, and absent a decision signed by all shareholders or a final court decision, the trade registry will not register the bank as a shareholder. The current practice confirms this, as there is no published case where a bank was successful in registering itself as a shareholder in the absence of all of the above documents.

In such a situation the bank would have to go to court in order to compel the other shareholders, including the borrower, to consent. The long duration of litigation in such cases does nothing but deprive the bank's guarantee over shares of any practical value.

This administrative hurdle is not any different if the borrower is a sole shareholder limited liability company. A document signed by the sole shareholder would be necessary for the trade registry, as in the case of a company with multiple shareholders.

The enforcement mechanism would be more straight-forward if the borrower would be a joint stock company (SA). In this case, the rule is that shares can be freely transferred to any other party. In addition, registration of the transfer in the company's shareholders registry is sufficient, as the registration formalities with the trade registry are not mandatory to give effect to the transfer of shares. Banks may have some issues when the borrower's articles of incorporation include certain restrictions (i.e., pre-emption rights, prior approval of the transfer by the board or the shareholders, etc.), however these can be relatively easily overcome if banks obtain a waiver or an approval for the transfer at the moment when the pledge is established.

2. How Does the Bank Foreclose on the Shares?

If the issues above sort themselves out, then in principle the foreclosure on shares should be quick. After a customary notification from the bank that the loan is overdue and immediate payment is required, the bank has two options at its disposal:

First, there is the statutory procedure. Law 99/1999 allows for the bank, through its own Bank Bailiff (Romanian: *executor bancar*) to put the shares up for sale or even transfer them directly to the bank if the pledge contains clauses to this effect.

The foreclosure occurs as a matter of urgency, the Bank Bailiff being required to inform by official notice the borrower and any interested creditors five (5) calendar days before the sale. No other formal procedure is required. In addition, the bank is required to sell the asset within a reasonable period of time and for the best price applicable on the market.

In such case, the borrower may oppose the sale within five (5) calendar days of receiving this notification, but there are not many reasons which can be put forward, two of these being that the debt has been paid or that the term for the sale is less than five (5) calendar days.

That being said, the process itself could be completed within a two-week period. However, in practice unless the bank itself becomes the holder of the shares, it would be more difficult to find buyers since such would most likely be reluctant to buy shares of a company pursuant to a private enforcement procedure instead of buying the asset itself.

There is also a common law (Romanian: *drept comun*) procedure, that basically auctions the shares, but it is rarely used.

3. How Long Does This All Take? Should the Borrower be Wary?

Under the statutory procedure, the bank in principle could foreclose on the shares in as quickly as fourteen (14) calendar days, irrespective of the type of company involved. However, for the reasons detailed above regarding Law 31/1990, due to restrictions and practical roadblocks to register new ownership at the trade registry (making it thus unattractive for a potential buyer), as well as coupled with banks' general reluctance to hold shares of companies (difficulty in valuing, owning, managing, and disposing of them), it is rare for a bank to foreclose on shares.

D. FORECLOSURE – WHAT CAN THE BORROWER DO? IS A REORGANIZATION FILING A FINAL HOPE?

We have outlined above how a bank can enforce its security. Now we address what options a borrower may have at its disposal:

1. Pay the Due Amounts

This may not seem entirely helpful, but it is important to note that once a Bailiff sends an official summons, the borrower has a last chance to pay within ten (10) calendar days. If the mortgaged asset is an income-producing property, then the borrower may also request the court for a six (6)-month delay, if it can prove that rental income from the property will cover all due amounts and interest accrued.

2. Legal Roadblocks

The borrower facing mortgage foreclosure may have two arguments at its disposal – neither of them particularly reassuring assuming that the mortgage and loan documentation is properly drafted. The first is to submit an emergency court motion for an injunction (Romanian: *ordonanță președințială*) arguing that there is, in fact, no default under the loan and that the bank has no right to foreclose. However, if the borrower has reached this stage, barring clear and convincing evidence to the contrary that the bank has no legal right to foreclose, it is likely that its application will be dismissed.

The second argument is to allege a procedural flaw – that the Bailiff did not respect the procedure in some form or fashion, i.e., did not respect time deadlines or methods of delivery, etc. In this regard, the borrower’s counsel should closely monitor the Bailiff’s actions. If there is some flaw, the borrower may submit an application to the court again via injunctive relief. If the court would agree that the procedure was not respected, it should require the Bailiff to perform the misapplied procedure over again from the start. But given the experience of Bailiffs in this regard, such a flaw is unlikely to occur.

3. Participate at the Foreclosure Auction

The borrower can consider attracting “friendly” parties to bid at the auction, including other Romanian companies owned by the borrower’s shareholder (assuming that there are no restrictions in this regard under the loan documentation). The only restrictions with respect to bidding at the foreclosure auction is that creditors of the borrower cannot bid for less than 75% of the auction starting price.

4. Open Insolvency Proceedings and Buy Time

Applying for insolvency to a court is also an option. Romanian bankruptcy rules allow for either: (i) an insolvency reorganization during which the borrower is protected from creditors and is allowed to restructure its business so as to hopefully re-emerge from the procedure as a healthy business, or (ii) if there is no hope of redress, outright bankruptcy and liquidation of the borrower’s assets with a view to covering the outstanding debts owed to creditors. Many borrowers that are special purpose entities owning a single real estate asset do not consider the option of opening insolvency proceedings under point (i) above. However, they should.

The borrower can file for this action relatively quickly (within generally 4 to 6 weeks) and, in principle, bankruptcy judges will allow the procedure to open (a bankruptcy judge may refuse to place the company into insolvency if it feels that its management is ‘playing for time’ or has no reasonable hope of reorganization). **The most apparent and direct advantage of opening insolvency proceedings is to buy time** – hopefully enough time either for the borrower to find a solution to its financial troubles or to try to force the bank to the negotiating table. Whereas a Bailiff foreclosure procedure as described above may usually take five (5) to seven (7) months, the commencement of a bankruptcy procedure would extend the procedure by at least a further four (4) to six (6) months (thus stretching the procedure out until final sale of the asset to approximately a year).

If the borrower has arrangements in place with investors to sell its business, applying for insolvency makes twofold sense: **During the time that proceedings are opened, there is an ‘automatic stay’ on all claims, which remains in place until the insolvency procedure is closed.** A “stay” means that all enforcement and court proceedings against the borrower are brought to a halt – the bankruptcy court working at the advice of the creditors committee and the judicial trustee are the only bodies permitted to take decisions. **This will prevent the bank from foreclosing on the asset or suing the borrower.** Further, in the event of a successful restructuring plan, the bank could find itself in a situation where it must accept the plan and see its debt rescheduled.

The downside is that the borrower may lose control of the company. As part of the insolvency proceedings, a judicial trustee is appointed (Romanian: *administrator judiciar*) who will in principle take over control of the company, or operate it together with the existing management.

The trustee's role is to protect the company's financial situation and oversee day-to-day payments. It must draft a report analyzing whether there are reasonable chances for the borrower to recover. To this end, the borrower must be able to demonstrate that it has reasonable chances to secure funding, investments or some other measures to address its situation. If not, the trustee will be forced to conclude that reorganization is not possible and proceed directly to bankruptcy and liquidation of the borrower's assets. The latter process takes months.

It is worthwhile to note that the trustee's fees are significant, usually anywhere between 3% and 12% of the value of the asset being sold in the case of liquidation.

In addition, the extra time gained by requesting the insolvency proceedings to be commenced is not a guarantee against the bank foreclosing if it is determined to do so. Should the bank be the majority creditor, as it usually is, it normally calls all the shots at the end of the day – thus it can decide on its own to oblige the trustee to put the borrower into liquidation in order to get its money. But it cannot do so before the statutorily-required steps are completed, which as mention above usually take at least four to six (4-6) months.

E. FINAL CONCLUSIONS

The distressed borrower's situation is not rosy and normally the bank holds all the cards. But the borrower should be aware that there are perfectly legal roadblocks and other measures at its disposal that could at least buy it time and possibly improve its bargaining position with the bank. In other words, not all hope is lost. A strategy should be established with the borrower's legal counsel as early as possible in the process.

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