

WORKOUTS FROM THE BORROWER'S VIEWPOINT

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I. Introduction

From a borrower's perspective, defaulting on a loan is not an optimal situation. The borrower faces potential foreclosure and possible personal liability for guarantors. The specter of bankruptcy may loom. So how do borrowers make the best of a bad situation?

For many borrowers, if the lender is willing, workouts offer a potential middle ground between bankruptcy and foreclosure. A workout is a negotiated solution to a distressed loan, where the lender accepts something less or at least different than the deal for which it bargained in the original loan documents.² A workout requires a willing and able borrower, a willing lender or lenders, and a project whose fortunes realistically can be reversed.

II. Borrower's Goals

A borrower's goals will vary from workout to workout. Limiting the liability of principals and any guarantors often is a primary goal. Another obvious borrower goal is to retain ownership of the real property collateral and related equity so that it can reap future gains from the property.³ Another objective may be to avoid foreclosure or bankruptcy, both to avoid the actual event and for the sake of the borrower's reputation.⁴ Other goals may include: (1) avoiding damage to other assets through cross-default or financial covenants in other loans; (2) extending loan maturity dates; (3) keeping current management in place; and (4) reducing loan payment obligations.⁵

III. Types of Workouts

Workouts can take many forms, which, depending on the nature of a distressed portfolio, can be combined. Forms include: (i) a loan modification; (ii) lender's assumption of control of the property; (iii) the borrower's conveyance of the property to the lender by a deed in lieu of

foreclosure; (iv) transfer of the property to a third party by sale; (v) a third party's completion of a construction project; and (vi) the appointment of a receiver for the property.⁶

IV. Keys to Retaining the Keys – Establishing and Maintaining Credibility

To convince the lender to allow the borrower to continue to own and operate the property, the borrower needs to establish and maintain credibility with the lender. Here are several aspects of that effort.

A. Address Problems Proactively

Once a borrower senses that it may be in trouble on a loan or loans, the borrower should address the problem proactively. The borrower should convene its team -- its accountant, its attorney, and the key principals -- to discuss matters and contemplate options. Rather than waiting for events to control the borrower, the borrower should prepare for and make strategic decisions about the situation.

B. Communications Strategy

A borrower's communications strategy is a central piece of its workout strategy. In most instances, particularly if the borrower wants to continue to own and operate the property, the borrower is best served by prompt communication of news – even (especially) bad news -- to the lender. For example, a borrower should not delay in informing its lender that a major tenant has elected to terminate its lease or has defaulted on the lease. No one likes to deliver (or receive) bad news but, in most cases, it is better to disclose than to hide or delay.

Prompt communication of bad news establishes credibility with the lender. The borrower may need some time to assess the situation and develop a credible plan. The borrower should let the lender know both about the immediate news and that it is preparing a plan.

In some instances, the borrower may determine that it should wait before disclosing bad news to the lender. Such a situation may exist, for example, if the borrower has the sense that

the lender will be adamantly opposed to a workout and the loan documents give the lender the right to call a default if, in lender's view, the value of the collateral is impaired. Regardless, the borrower should decide when and how best to communicate bad news to the lender.

C. Cash Strategy

In a workout cash is king. How a borrower handles cash can bolster or destroy a borrower's credibility with the lender(s). If the borrower's chief goal is to avoid foreclosure, particularly if the loan documents give the lender discretion in declaring a default, a time of default in the debt service is not the time for principals to pull cash from the project for unscheduled payments to principals. If there are loans from principals or affiliates to the defaulting borrower, default under the prime loan on the property is not the time to call those loans.

A defaulting borrower needs to look closely at the cash flow from a property and the property's cash needs. A critical issue is the extent to which cash flow from the property covers the debt service on the property. The borrower also should examine the property's needs. While the borrower may want to curtail expenditures to conserve cash (perhaps for a potential principal pay-down as part of a loan modification), neither the borrower nor the lender wants property maintenance neglected.⁷

The borrower should assess other cash needs for a turnaround – consultants, accountants and lawyers.⁸

Lenders, on the other hand, will want as much cash as possible to go to them. The cash battle is often the “biggest issue in a workout.”⁹

D. Assessing the Facts

To evaluate workout possibilities and prepare itself for workout negotiations with the lender(s), borrower needs to assess in a comprehensive fashion the problem project(s), loan

documents and other agreements, the market, the status of entities, principals and owners, and the position and perspective of the lender(s).¹⁰

1. Property/Properties/Project Review

The borrower should review the troubled project or projects, as well as borrower's other properties.¹¹ Although a borrower may have one particularly problematic loan, it may not be an isolated case.¹² A significant issue regarding the properties is their respective values. Borrower may want to consider obtaining appraisals on properties, especially those that it is considering placing on the market. The borrower should determine whether the properties are ready to lease or sell or the extent to which additional work is required to bring them to market.¹³

As part of reviewing each property, a borrower should analyze its leases. When do the major leases terminate? Do tenants have termination options? What tenants are in default or at risk of default? To what extent have tenants remained current with their rent obligations? As part of its stabilization plan, a borrower may want significant tenants to extend their leases.

2. Document Review

The borrower should analyze the documentation for each of its outstanding loans-- acquisition loans, construction loans, equipment loans, lines of credit and other loans. In performing this analysis, a worksheet such as the one attached to the materials may be useful. The chart's categories include the lender, the named borrower, payments due, guarantors, maturity amount and date, extension options, and special terms. The borrower should give particular attention to any carve-out guaranties. The borrower does not want to trigger liability on those guarantees through its conduct during default. For example, one carve-out may be diversion of rents when the borrower is in default, which is subject to different interpretations between the lender and the borrower.¹⁴

The document review serves multiple purposes. The borrower renews, or gains an understanding of, its obligations under the loan documents. The review also is an opportunity for the borrower to pinpoint items it might want to fix in a loan modification agreement. For example, a borrower might want to try to rid the documents of the lender's ability to determine discretionary defaults. One example is lender's ability to call a default if the value of the collateral is materially impaired. A borrower also may want to make capital infusions earlier by easing restrictions on transfers of interests or subordinate debt.

The borrower should review correspondence with the lender for potential defenses, lender waivers, and payment history.¹⁵ In assembling the borrower's documentation, pay particular attention to missing items. Are closing binders for each of the loans available and complete? A borrower may also consider conducting title and lien searches to determine whether there are holes in the lender's security interests in the real or personal property.

3. Market Analysis

The root cause of a borrower's difficulty often is that market conditions have changed from when the project was planned or that market conditions were not properly analyzed.¹⁶ A borrower should undertake a fresh analysis of market conditions, perhaps with a new team who feels no need to justify past decisions.¹⁷

4. Entities/Owners

Another part of the borrower's analysis should be to review the guarantors, borrowers, affiliates, and the owners of those entities, as well as the entity documents for the borrower, the guarantors, affiliates, and other affected entities. A borrower or its general partner may have liability to third parties other than the lender in connection with the distressed asset.¹⁸

Limited partners may have sources of capital that can help save the deal. Partnership agreements may give limited partners rights over loan agreements and modifications and other courses of action that borrowers may wish to take.¹⁹

5. Lenders

The borrower should also take time to understand the position of its lender(s). Who is the lender? A community bank, for example, may have more flexibility than a special servicer.

Consider as well whether the lender is truly interested in owning the property. Is the lender in a position to cover operating shortfalls? Does it have management experience? If the lender holds a subordinate interest in the property, can it afford to keep senior lenders current in their payments and prevent foreclosure?²⁰

A borrower may also try to determine whether the lender has written down the loan.²¹ A lender often will try not to reveal this information but if a borrower can ascertain it, the information may be useful to the borrower.²²

The borrower also should try to assess the outcomes for the lender in the event of a foreclosure or a bankruptcy filing. Those outcomes put parameters on workout negotiations. For example, a lender will want the resolution from a workout to be at least as favorable to it as would result from a foreclosure.

Much information about lenders is publicly available. For example, the “call reports” on the Federal Financial Institution Examination Council website (<https://cdr.ffiec.gov/public>) provide a plethora of information on lenders.

6. Nature of the Default

The nature of the default will also impact the borrower’s strategy. If the borrower has been making its regularly-scheduled payments of principal and interest but is unable to refinance for a balloon payment coming due soon, that is one category of default. If the borrower is failing

to pay its debt service, on the other hand, the nature of the default is in the lender's eyes more severe.

V. Developing a Plan

A borrower's challenge is to develop a realistic plan for how to accomplish its goals that the lender(s) will accept. The shape of a plan obviously depends on the borrower's objectives and underlying facts. The borrower needs to be able to specify a scenario for paying off the loan or making the lender as whole as possible.²³ For instance, if the borrower's goal is additional time for repayment, the borrower needs to show how time will stabilize the asset.

The plan also depends in part on the nature of the default. For instance, if the borrower is unable to refinance for a balloon payment coming due, the solution may be a lender write-down coupled with an additional capital infusion from the borrower.

If cash flow cannot support the debt service, a borrower may ask for a reduction of the interest rate. At a minimum, the borrower's plan should demonstrate to the lender that the plan is no worse than foreclosure or bankruptcy. "Otherwise, most lenders will quickly conclude that they are better off cutting their losses instead of proceeding with a troubled project."²⁴

Another alternative is to give the lender a "foreclosure equivalent - control of cash flow, the right to approve and propose the sale of the property at less than the lender's loan amount and other rights over the property."²⁵

VI. Approaching the Lender(s)

After the borrower has evaluated the facts and developed its plan for turning around the troubled project(s), the borrower should approach its lender(s) with its proposed plan. As noted above, the key to winning lender's acceptance of the plan is to convince the lender that the borrower is in a better position than lender to maximize the lender's recovery. The borrower

should present a realistic plan that its analysis supports. The plan should be achievable, not based on false hope.²⁶

A. Choose the Tone

A borrower should carefully choose its tone with the lender. In many instances, a cooperative “we’re in this together” approach will be the best way to approach the lender. In other instances, particularly if the lender has caused difficulties, by, for example, wrongly failing to advance construction funds or if the borrower has strong defenses, a more aggressive posture may be warranted. If discussions begin in a confrontational mode, however, it may be difficult to find an alternate paradigm.

B. Two-Step Process

1. Forbearance Agreement

Often the first step for negotiations is a forbearance agreement. This effectively is an agreement of the parties to preserve the status quo so that loan modification negotiations can occur. A forbearance agreement gives both the borrower and the lender time. For a borrower, a forbearance agreement will forestall foreclosure proceedings and allow it time to reach an accommodation with the lender. The borrower should try to limit additional borrower obligations, covenants, representations and/or warranties that the lender may seek in a forbearance agreement.

2. Loan Modification

A second document in workout negotiations often is a loan modification agreement. That agreement can take several forms, which may include any or a combination of the following:

- (i) A reduction of interest rates charged by the bank on its loans;
- (ii) The payment of interest only with a moratorium on principal payments for a specific period of time;

- (iii) The permission of the bank to sell surplus manufacturing assets or real estate;
- (iv) An increase in the borrowing base for the bank's revolving line of credit;
- (v) A waiver or renegotiation of restrictive covenants in the bank's credit agreements, such as the maintenance of financial ratios; and
- (vi) The release of security interests and liens in collateral or their subordination to obtain additional financing from another source.²⁷

In order to induce the lender to consent to some sort of loan extension or modification, a borrower may need to give additional concessions to the lender. Examples include:

- (a) a partial paydown of the principal portion of the loan;
- (b) the implementation of a cash management system for revenues from the property;
- (c) the addition of further collateral in the form of deeds of trust on other real property or pledges of the revenue therefrom;
- (d) pledges of membership interests in the borrower or other related entities owning other collateral;
- (e) the subordination, termination or tolling and accrual of property management fees;
- (f) the addition of further guarantors of the loan or the modification of existing non-recourse carve-out guaranties into full repayment guaranties or other forms of "springing" guaranties;
- (g) adding additional non-recourse carve-outs to the loan;
- (h) modification of existing loan-to-value, loan-to-costs, debt service coverage ratios or other financial or liquidity tests for the borrower or guarantors;
- (i) changes in management of the borrower or property;
- (j) the termination of any further funding obligations or creation of new conditions precedent or other phasing to such future funding;
- (k) the creation of "equity kickers" by which the lender participates in any upside in the economic performance of the secured real property; and

- (1) a consent judgment to the hiring of a receiver or a foreclosure, a conditional deed to the real property collateral or some other sort of confession of judgment.²⁸

C. Multiple Lenders

Workout negotiations are sufficiently challenging when the borrower only has one lender. When multiple lenders are involved, either through subordinate and/or mezzanine debt and/or securitized debt, or multiple problem projects, the challenges for a workout grow exponentially. Lenders likely have conflicting objectives, whether they are on the same project or different projects. All want available cash.

One strategy is to find a sympathetic lender and start negotiations with it. It is important, however, to develop a global solution. If multiple projects are in trouble, the borrower needs to deal in some manner with all of them. The same keys to retaining the keys apply. The borrower needs to be able to convince the lenders (or the special servicer) that it is in the best position to maximize the assets' values and the lenders' recoveries.

VII. Conclusion

A loan default is a difficult time for any borrower. Through preparation and carefully considered strategy, a borrower may be able to make the best out of a bad situation.

Borrower Worksheet for Problem Loan

Loan / Project Name	
Loan Purpose	
Borrower(s)	
Lender	
Outstanding Balance	
Monthly payment	
Maturity Date / Amount	
Extension options	
Guarantor(s)	
Extent of Guaranty / Non-Recourse Carve-outs	
Grace Periods	
Collateral	
Cross-Default	
Cross Collateralization	
Prepayment premium (penalty)	
Events of Default	
Financial Covenants	
Subordinate Lender	
Mezzanine Lender	
Special Terms (e.g., call option)	

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² W. Wade Berryhill, Joel B. Eisen, & Michael J. Herbert, *Structuring Commercial Real Estate Workouts: Alternatives to Bankruptcy and Foreclosure*, § 1.02 (2d ed. 2010).

³ See Douglas Van Gessel and Katharine E. Allen, *Real Estate-Secured Loan Workouts: The Borrower's View*, Pratt's Journal of Bankruptcy Law, April 2009, 262.

⁴ See Berryhill, *supra*, at § 3.03.

⁵ See Van Gessel & Allen, *supra*, at 263.

⁶ See C. Berger and Q. Johnston, *Land Transfer and Finance*, 318 (4th ed. 1993) and Black, *Loan Workout Strategies*, 4 Prob. & Prob. 39 (March/April 1990), cited in Berryhill, *supra*, § 1.02 fn 3.

⁷ Practical Counsel (practicalcounsel.wordpress.com), *Workouts 101, Part 2: Borrowers' Leverage*, June 20, 2009.

⁸ John M. Koneck, *Preparing for a Real Estate Workout*, Minnesota Real Estate Journal, Sept. 2008, v. 24 n 9.

⁹ *Id.*

¹⁰ See William G. Murray, Jr., *What to do about the Problem Project*, Prac. Real Est. Law., Sept. 2007, at 42-43.

¹¹ Berryhill, *supra*, § 3.01, at 3-3.

¹² *Id.*

¹³ Murray, *supra*, at 42.

¹⁴ Berryhill, *supra*, § 3.01 fn. 2.

¹⁵ Berryhill, *supra*, § 3.01, at 3-4.

¹⁶ Murray, *supra*, at 42.

¹⁷ *Id.*

¹⁸ Berryhill, *supra*, at § 3.01, at 3-5.

¹⁹ *Id.*

²⁰ See Joshua Stein, *Selected Issues in Troubled Commercial Real Estate Loans*, Materials for Presentation at American College of Real Estate Lawyers Conference, Washington, D.C., October 29-31, 2009 at 9.

²¹ *Id.* at 8.

²² *Id.*

²³ See Van Gessel and Allen, *supra*, at 270.

²⁴ Berryhill, *supra*, § 3.03, at 3-7.

²⁵ Berryhill, *supra*, § 3.03, at 3-7.

²⁶ Berryhill, *supra*, § 3.04 at 3-13.

²⁷ Patrick E. Mears *et al*, *A Brief History of Workouts and Foreclosures*, *Prac. Law.*, Feb. 2005, 53, 54.

²⁸ Van Gessel and Allen, *supra*, at 271-272.