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LOAN WORKOUTS

Part I — Note to Lenders

It is news to no one that these are challenging economic times. What began as a subprime residential loan calamity in March 2007 has spread to economy wide weakness impacting consumers and business alike. Commercial real estate loans and business loans are no exception. With the current economic stress, commercial real estate loans, including especially construction loans and development loans, and business loans generally, are on an upward trend of default. The FDIC and other financial institution supervisory authorities have expressed concern. They have also expressed the need for close attention and creative problem solving to limit loan losses. Lenders should take heed.

Every commercial loan provides for legal and equitable remedies in the event of default. Lenders and their lawyers, accustomed to relying on the remedies contained in their loan documents, often do what is expected: When a borrower falls behind on its payments, or violates debt coverage ratios or other loan covenants, the lender declares a default, imposes an increased default rate of interest, accelerates the indebtedness and commences foreclosure or other loan enforcement proceedings. The question is: Under current economic conditions, does this make sense? The answer is: Sometimes yes; sometimes no. More and more frequently, the answer is no.

Think about it. The objective of loan enforcement is, or should be, to maximize recovery. In stable economic times there may be many circumstances where it makes sense to follow the predictable enforcement scenario described above. When times are bad, a critical analysis must be made to calculate what action will, in fact, maximize recovery.

In tough economic times, with property values declining due to a glut of defaults, rising storefront vacancies, tightening credit standards and skittish capital markets imposing higher yield requirements to offset rising risks, lenders must ask themselves: If I successfully foreclose this property, what am I going to do with it? What is my expected recovery? Declaring a default and mindlessly proceeding with foreclosure proceedings may be exactly the wrong solution.

There is a legal maxim that has equal application to lenders: "*Ut vos reperio vestri in lacuna, subsisto fossura.*" which roughly translates to "When you find yourself in a hole, stop digging."

What works during good or even "normal" economic times, may not make economic sense during an economic downturn.

To survive a sizable loan default during times of widespread economic weakness a lender must think outside the box. The lender must focus on damage control. An elevated level of business acumen must be exercised.

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The lender's underwriting criteria for loan origination may be irrelevant. What was required to originate the loan may not work now. Simple solutions are rarely at hand. The objective is to avoid, or at least minimize, loss. Here's how:

First and foremost, try to communicate with your borrower. Try to find out what is going on in the borrower's business that has resulted in this default. It is often more effective to look for solutions than it is to threaten the borrower with forced collection and foreclosure.

True. You may be annoyed that the borrower has not contacted you. Lack of communication raises suspicion and stress. The borrower should be contacting you, but this is no time to stand on ceremony.

Your borrower is likely under stress as well. Likely embarrassed he or she is not keeping up. Hoping against hope that things will turn around. If this loan is necessary for your borrower to stay in business, borrower may be emotionally paralyzed into inaction with disbelief at the borrower's financial predicament. The borrower may be afraid to call you out of fear of humiliation. This may be especially true if the borrower has historically been successful in business. For your borrower, this is likely a new and traumatic experience.

I'm not pointing this out because I want you to feel sorry for the borrower. I'm pointing this out to help you understand the borrower's frame of mind and to put the loan default in context. This is not personal. Typically the borrower is not trying to rip you off. It is unlikely the borrower is using business proceeds to live the high life at your expense.

There are exceptions, sure. Part of what you need to do when a loan starts to lag in performance is to find out what is going on. If, in fact, the borrower is taking you for a ride by diverting funds to personal extravagances instead of paying your loan then don't delay. Have a receiver appointed. Do what you must do to protect your collateral. In this case your collateral may be a wasting asset. Time is your enemy.

Assuming this is not the case, however, and that borrower has just fallen on hard financial times, try to understand the nature of the problem. Is this just a temporary cash flow problem? Did the borrower's primary tenant or customer slow down its payments? Did a key tenant file bankruptcy or close its business due to economic stress? Has a government payer suspended payments while a new fiscal budget is approved? Has an unexpected rise in fuel costs or other costs soaked the profit out of a fixed-term vendor contract borrower is obligated to perform?

If the borrower's cash flow problems are temporary, does it make sense to declare a default and compound the borrower's problems? Will this maximize your recovery?

If you work with the borrower, can the borrower pull through the current economic distress and get back on track? Does it make sense to extend borrower a temporary working capital line of credit, or increase an existing line of credit, to solve borrower's current cash crunch? Lending a borrower additional funds when the borrower is in default may seem counter-intuitive, but will it increase your likelihood of achieving a full recovery? What are your chances of recovery if you don't?

Is a loan modification agreement appropriate? What about extending the repayment schedule? Or reducing, instead of increasing, borrower's effective interest rate? This does not necessarily mean actually reducing the borrower's rate of interest, but perhaps agreeing to reduce the amount payable currently and accruing the rest.

Consider an example where the loan rate is 8% and the default rate is 12%. If the borrower is experiencing cash flow problems that have resulted in borrower's inability to remain current with payments based on a loan rate of 8%, is it reasonable to think borrower will be able to keep up with payments if the interest rate is increased to 12%?

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In a loan default setting, one of the most misapplied financial maxims is: “higher risk requires a higher rate of return”. This maxim is used as one of the justifications for applying a higher interest rate in the case of default. There is no question a loan in default presents a high financial risk.

While there is a reason to provide for a higher default interest rate, this is not it. The valid reason is to serve as a disincentive for default. But where a default is beyond the practical control of the borrower, should it necessarily be imposed?

The “higher risk/higher rate” maxim is really a principle of capital attraction. To “attract” capital for debt or equity financing, higher risk really does require a higher rate of return. Unless you are selling your defaulted loan, however, attracting capital is not the issue. You have already funded your loan. Your task now is to maximize recovery.

At the very least you need to recover your principal. If you can recover your costs of collection and accrued interest, better still. Ideally, you will recover it all, including your higher rate of accrued default interest. Recognize, however, that what is ideal may not be what is realistic. Once again, the guiding light is maximizing recovery. Sometimes making a profit is not an option. Minimizing loss may be the only viable strategy.

If you review borrower’s financial condition and determine borrower’s cash flow difficulties are temporary, instead of increasing payments to cover 12% default interest, consider whether it would make more sense to base payments on 4% and accrue the other 8% until borrower’s cash flow situation improves.

If you determine borrower’s cash flow difficulties are permanent and the best solution is to liquidate the collateral, consider whether you will recover more through a foreclosure sale or through sale as a going concern? What do you need to do to facilitate sale as a going concern? Who should run your borrower’s property or business in the meantime? Is the extra cost of appointing a receiver or trustee going to result in a greater recovery for you?

On numerous occasions I have dealt with lenders who insist on rigidly sticking to their original lending criteria. Frequently, the lender demands that the borrower raise more capital to cure borrower’s default and restore lender’s required loan ratios. This is a great solution for lender if it is possible. The question to ask is how realistic is it and will it really solve the underlying financial difficulties. If the borrower does not have its own funds to invest, where is the additional capital supposed to come from?

Recalling the maxim for capital attraction stated above, what rate of return will prospective investors require to induce them to inject more capital into the borrower’s already struggling enterprise? How will this high rate of return be realized? What impact will that have on borrower’s future prospects for loan compliance? In the long run, will this strategy improve or impair your chances for full recovery?

In every case, the lender’s mantra should be: maximize recovery; maximize recovery; maximize recovery. . . Every lender decision after default should be focused on this objective. The path to maximum recovery may not be obvious, and in some cases may seem counter-intuitive. Still, it must be your guiding light.

As we start down the path of considering a loan workout, it is essential that we obtain a clear and accurate picture of borrower’s true financial circumstances. If you are not sure about the quality of financial information we are getting from your borrower, consider requiring that borrower engage an independent financial consultant. The consultant should be professional and qualified. The consultant must understand that although he or she is being paid by the borrower, the consultant owes a fiduciary duty to accurately report to the lender.

Fortunately, there are a lot of qualified professional financial consultants. They are not cheap, but they are often worth the added expense. Be sure the one you pick knows your borrower’s business or can learn

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it very quickly. Require a strict and frequent reporting schedule. If you determine borrower's financial situation is not going to improve, be ready to pull the plug and do what you have to do to maximize your recovery.

If the borrower won't voluntarily agree to engage a financial consultant, go ahead and declare a default then require employment of a financial consultant as a condition to entry into a forbearance agreement. A forbearance agreement is a good idea in all events. It should include an acknowledgement of the loan default and a waiver of defenses as conditions to your agreeing to work with the borrower to try to find an amicable solution to borrower's financial crisis.

While you gather information and work with the borrower, have an attorney review your loan file to make sure you have everything you need in the event you must resort to forced collection and foreclosure. It may surprise you how often your documentation is incomplete or inaccurate. At a minimum, make sure your Note, Mortgage, Security Agreement and Guaranties are signed; that the Mortgage is recorded and your security interest is perfected.

What is the value of that personal guaranty now? Require current financial statements from the borrower and each guarantor. Determine whether the borrower has additional capital available or additional collateral to pledge to fully secure your loan. Make sure all necessary corporate resolutions and other authority documents are executed and in your loan file.

As you work with the borrower, you must always consider the risk that borrower may file bankruptcy. Understand the consequences.

Bankruptcy proceedings are often very expensive. For this reason, they may degrade rather than enhance your recovery, even as a secured lender. Perhaps to your surprise, being over-secured can create nearly as many problems in bankruptcy as being under-secured. The problems are not exactly the same, but each has its own challenges.

If your loan is under-secured, you will likely be treated as a general unsecured creditor for that portion exceeding the value of your collateral. To avoid this risk, it is not uncommon for some lenders to proceed to the opposite extreme of grossly over-securing their loans. This strategy, while in the long run preferable to being under-secured, is not without issues.

In cases where the borrower has significantly over-secured its loan, a bankruptcy judge has the authority to significantly reduce or suspend the borrower's obligation to make current debt service payments by determining the lender is adequately protected by the value of its collateral. That can mean no payments whatsoever on your loan while the bankruptcy is pending. If the cash flow from loan repayment is important to lender, this could create a serious problem.

The point of all of this, for lenders, is that to maximize your loan recovery, you must exercise good business judgment. Blind adherence to conventional remedies for breach of contract may not be your best answer. Be creative and focus on what will maximize your recovery under the unique circumstances of this particular loan default with this particular collateral and this particular borrower.

While doing this, do it in a way that does not expose you to lender liability. At all times you must maintain your role as a lender acting responsibly to maximize your recovery. Avoid any action that may transform you into a role tantamount to that of a business partner. This is not difficult, but may sometimes require you to walk a fine line.

Taking a creative approach to loan defaults and focusing on ways to work with your borrower are often essential elements to minimizing loan losses and maximizing recovery. This is the essence of an effective loan workout.

Thanks for listening,
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