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LOAN WORKOUTS
Part II — Note to Borrowers

Thirty years ago, a classmate of mine went to work for a law firm specializing in mortgage foreclosures. His pet name for defaulted borrowers was “mooches”. His philosophy was that defaulted borrowers were basically crooks. They had taken his client’s money and wouldn’t pay it back. The distinction between unwillingness to repay and inability to repay didn’t matter to him. Changes in circumstances didn’t matter to him. To his mind (what little of it there was) it was as clear as night and day: the mooches were no better than thieves. He was out for blood. To him, it was personal.

Unfortunately, we still sometimes deal with lenders and attorneys like my former classmate. They would rather punish a defaulted borrower than work to maximize their recovery. For them, a loan workout is a sign of weakness. With them, a voluntary loan work out may be difficult. We can try to work with these lenders and their attorneys to show them how the lender may be better off taking a less adversarial approach but, like it or not, lenders – like defaulted borrowers – don’t always make rational choices. Fortunately, however, they usually do. Sophisticated lenders with sophisticated lender’s counsel understand that in a loan default scenario the primary objective is to maximize the lender’s recovery, and recognize that the path to maximum recovery may not be as obvious as it might seem.

If you are a borrower reading this, perhaps your business or commercial development is in financial distress, or you want to prepare yourself in case matters gets worse. I understand. These are tough economic times. Unless you have faced a severe financial crisis before, there is little reason to know much about this topic.

You are not alone. Although you may have never before experienced financial distress at a level which has caused you to default on an important real estate or business loan, structural changes in our economy and other financial stresses outside the control of borrowers do take their toll. It does not make you a bad person or necessarily suggest you have exercised poor business judgment. Sometimes a good business decision under one set of circumstances becomes a disaster when conditions change. Unfortunately, your business or commercial investment is where the pain of adverse change is felt. Bitter consequences may become unavoidable. To paraphrase a cliché, in times of economic trouble, your business or real estate development is where the rubber meets the road.

Speaking of rubber, that’s a perfect example. I represented a client recently that manufactured rubber and plastic toys for large retailers. The way that business works is that manufacturers contract in January or February to deliver their rubber and plastic toys to retailers between August and November, in time for the Christmas shopping season. The wholesale price per unit is agreed upon at the time the contract is executed. The toys are then manufactured between March and October. It’s a pretty good system. The product is pre-sold before being manufactured. The risk of being stuck with an inventory of unsold toys is minimal. For many years this system worked perfectly.

As you may have guessed, the unexpected and drastic rise in petroleum prices created a problem. In case you don’t know, rubber and plastic are petroleum based products.

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The cost of manufacturing rubber and plastic products has always fluctuated to some extent based upon the world market price for crude oil. The customary market risk of small price fluctuations was factored into the delivery price. What was not factored in was the sudden dramatic rise in crude oil prices we have experienced over the recent past. As a consequence, what began as a built in profit turned into a built in loss. It's not surprising that this client fell on hard economic times and defaulted on its loans. Did that mean the client's managers were bad people? Does it even mean they used poor business judgment? Beyond these questions is the important one: How do we best deal with the client's defaulted real estate and business loans?

As another example, consider the client who for generations has been in the wholesale bakery business. It's a huge business. The client's bakery goods are sold in grocery stores and convenience stores throughout the United States.

Financial difficulties arose, but not from an economic recession or rising costs of raw materials. This client's problems arose from a book; a diet book of all things: *Dr. Atkins' New Diet Revolution*. You may recall it was the rage a few years back. The fundamental premise of the Atkins diet is that carbohydrates are bad and will make you fat. Never mind that good nutrition and loosing weight involve more than just cutting carbohydrates, that was the premises of the Atkins diet and consumers bought into it big time.

A consequence of the Atkins diet was that consumers greatly reduced their intake of bakery products, a key source of carbohydrates. Bakery sales dropped precipitously. Bakers with high fixed costs suffered unprecedented losses. Does this make bakery owners poor business people? Did this foreshadow the end of the bakery industry? We don't hear much about the Atkins diet anymore. It was a temporary consumer phenomenon. The bakery industry is on the rebound.

I'm not relating these examples because misery loves company. My purpose is to give you a frame of reference as you prepare for discussions with your lender. And discuss, you must.

One of the most fundamental mistakes borrowers make is failure to communicate with their lender. The strategy many borrowers seem to follow is one of beat the clock. The premise seems to be that somehow, someway, their financial distress will be resolved before their lender notices they are falling behind. The obvious question is, how? What will be different tomorrow than it is today? Do you really think your financial problem will fix itself in the next thirty days? How, exactly, is that to occur? Unless you have an ironclad financial solution that is virtually certain to occur (like, for instance, your two year jumbo CD is maturing next week at which time you will liquidate the CD and pay off the loan or, at least, inject sufficient funds to overcome your financial woes), communication is essential. Even when you have an ironclad solution, communication is a good idea.

I understand you may be embarrassed. For a business person accustomed to success, facing a loan default is a humbling experience. It can be a hard conversation to have. The alternative, however, can be worse. Failure to communicate raises suspicion and doubt.

If you have an ironclad solution, acknowledge to your lender that you have a temporary cash flow problem and explain how you are going to fix it. For this to work, however, you must carry through and actually fix your problem. Acknowledging a problem then fixing it tends to build lender confidence in a borrower. Trust is a valuable resource. Acknowledging a problem and suggesting a solution that does not come to pass has the opposite effect.

If you do not have an ironclad solution you are certain will come to pass in the immediate future, your best course is to take an alternative approach. That approach is the "loan workout".

In a loan workout, you acknowledge you have a financial problem, then seek the lender's indulgence as you strive to fix the problem over time. The amount of time a lender may be willing to work with you will

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depend on two things: (1) the lender's confidence that your solution will really work; and (2) belief by your lender that it will not be worse off by waiting to foreclose.

Each of these is important, but the second is likely most important. The lender is interested in maximizing its recovery. It does not want to lose money any more than you do. If there is a substantial risk that your lender will recover less if it delays enforcement, your lender will not likely wait.

Your lender's level of confidence that the solution will really work likewise depends on two factors: (i) your lender's confidence in the solution; and (ii) your lender's confidence in you and your ability to implement the solution.

If you can't convince your lender that the solution you propose is viable, your loan workout efforts will go no where. Likewise, if you can't demonstrate to your lender that it will likely recover more if it works with you than if it pursues default remedies, forbearance from your lender is unlikely. Finally, if your lender does not trust your ability and commitment to carry out the solution, the lender will not likely wait to start enforcement proceedings.

Understand that from the lender's perspective, the loan default is really not about you. It is about the lender. What is the best course of action for the lender?

You may think this is unfair. You may believe that because you have been a loyal and profitable customer to the lender over time, the lender should bend over backwards to help you even if its risk of loss is rising. The hard news is: its not going to happen. It doesn't work that way. The only reason a lender may even consider the fact that you have been a loyal and profitable customer is if the lender believes there is still more profit to be made from you in the future. Commercial lending is a business. Lenders don't stay in business by voluntarily losing money.

Likewise, from your perspective, the loan default and loan workout are really not about the lender. As a defaulting borrower, finding a solution for a loan default is about what is in your best interests. If you have no financial exposure and little or nothing to gain by working through the loan default, it's a good bet you won't. On the other hand, if you have substantial equity invested or you have personally guaranteed the loan to your lender, you will likely work to do what is necessary to pay off the lender, but not for the lender's sake, for your own sake.

The reason a loan workout is even plausible is because, in many situations, what is good for the borrower is also good for the lender – at least to some degree. Since a secured lender will get its money before you get your equity, actions that protect your equity are typically beneficial to the lender. Beware, however, that the converse is not necessarily true. Since a secured lender will be paid before you receive your equity and before you are relieved from liability under your guaranty, a lender may well choose to sacrifice your interests to protect its own.

What does this mean to you? It means you have to structure a solution that protects your lender so your lender will give you time to save yourself. It also means you have to watch your backside while pursuing a financial solution.

To do this, you need to evaluate and understand all of your legal options. Determine any defenses you may have to enforcement of the loan or enforcement of your personal guaranty; any viable claims you may have against your lender that may lead to lender liability; the benefits and burdens of filing for bankruptcy protection and how that will likely affect your lender; and you must calculate the lender's recovery risk if you stop operating and the lender is forced to foreclose on its collateral rather than being able sell the collateral as part of a going concern. Be prepared to use all the tools and remedies at your disposal to motivate the lender to proceed in a manner that protects your interests while reasonably protecting its own.

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Understand, however, that any solution you devise to protect your interests must be a viable solution that protects the lender as well. This is the only basis upon which the lender will cooperate in a loan workout. Like it or not, if the loan was properly documented and adequately secured, and provided the lender has not taken any overt actions that expose it to a legitimate lender liability claim, the secured lender has the upper hand.

The Seven Principles of Loan Workout Negotiations:

The following principles of loan workout negotiation are, for this article, presented from the perspective of the Borrower, but they apply equally to the Lender. To apply them from the Lender's perspective, simply substitute "Lender" for "Borrower" and *vice-versa*.

The Borrower's Loan Workout Principles:

1. To get what you want you must give the Lender what it needs.

2. What the Lender needs is often less than what the Lender wants.

3. What the Borrower wants is often more than the Borrower actually needs.

4. Borrower and Lender often don't need as much as they believe they need.

5. The loan workout objective must be for each party to get all that it actually needs and, if possible, some of what it wants.

6. It is in the overlap of what the Borrower and Lender want above what they legitimately need that there is room for compromise.

7, To effectively negotiate a Loan Workout, it is essential for each party to have a realistic understanding of its actual bottom line needs, and the actual bottom line needs of the other. To "win" the loan workout negotiation, you allow the Lender to get all of what it needs while you get most of what you want.

Borrowers and Lenders typically have a clear understanding of what they want as they enter into a loan workout negotiation. Unfortunately they often fail to acknowledge, even to themselves, their actual bottom line needs. Even when they have clearly analyzed there own needs, they seldom have the insight or willingness to analyze and understand the other party's actual bottom line needs.

To make loan workout negotiations even more challenging, even when a party clearly understands its own bottom line needs it is not uncommon to withhold that information from their representative negotiating on their behalf, often out of fear their representative will settle for less than what they want.

While I don't recommend this approach, it is not necessarily fatal. It can become fatal to the loan workout negotiation process, however, when what you insist is your bottom line need prevents the other party from getting what it needs. It can then become what is aptly referred to as a "deal killer".

To most effectively and successfully negotiate a loan workout, three tactical elements are recommended.

The first is to negotiate through a representative. This creates a buffer that allows hard fought positions to be compromised when necessary with minimal damage to the credibility of your negotiator. This

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is critical because a large part of any successful negotiation is credibility with the other party, which requires conscientious trust building to convince the Lender you are acting in good faith.

Second, be sure you select a skilled and knowledgeable negotiator you trust to work diligently in your best interests, then be open and honest with your negotiator as to what you want and what you actually need. This is important because effective negotiation requires flexibility and creativity to maneuver the negotiation to a successful conclusion. If your negotiator does not know what you actually need as compared to what you merely want, opportunities to maximize your benefit may be lost through unnecessary intransigence as to your stated positions.

Third, have a workable "Plan B". If you do not have a workable Plan B, you are at a tremendous disadvantage in bargaining power.

Make no mistake. Negotiating a loan workout is not an easy way out. Any and all expenses the lender incurs will be yours to pay. That includes attorneys fees – both the lender's and your own – fees of inspectors; fees of consultants; fees of accountants to examine your books and records; fees of a financial agent to monitor your cash flow; fees of title insurance companies; and every other expense reasonably incurred to the collect the debt.

This is one more reason to look for real solutions that will take hold quickly and have a substantial likelihood of success. Your collateral may be a wasting asset that is declining in value by reason of your default. Your lender won't wait long for you to find and implement a solution.

The legal maxim I suggested to lenders in Loan Workouts, Part I – Note to Lenders applies equally to borrowers: "Ut vos reperio vestri in lacuna, subsisto fossura" which translates roughly to "when you find yourself in a hole, stop digging".

If there is no viable solution to your financial disaster, stop digging. You are only getting yourself deeper in debt.

This does not mean, however, that you should stop searching for a viable solution when you are merely on a downward slide. Finding a way to preserve your investment, or at least minimize your losses, makes perfect business sense.

Understanding how to do this requires knowledge and experience. Seek competent help. You will need it.

Thanks for listening,

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