SHUMAKER

Shumaker, Loop & Kendrick, LLP

KNOW THYSELF AND IT WILL WORK OUT:
WORKOUT OF COMMERCIAL REAL ESTATE LOANS IN TODAY'S ECONOMY

BY: MOSES LUSKI

I.
THE PROBLEM:
LACK OF LIQUIDITY IN THE BANKING SYSTEM RESULTS IN A TIGHTENING OF CREDIT AND CREATES A SEVERE RECESSION

The unprecedented recession that befell the American economy commencing in the Fall of 2007 and from which we are just beginning to emerge has created extraordinary problems for all commercial enterprises that rely on the use of credit to conduct business operations. The present calamity manifested itself in a bank liquidity freeze which reduced lending to a trickle. The lack of credit in turn affected general economic activity, reducing the revenue streams which businesses rely upon to pay existing indebtedness, including indebtedness secured by commercial real estate. This destabilizing feedback loop has put both prudent and recklessly managed businesses under extreme economic pressure which in most cases could not have been anticipated. The discussion which follows deals with the workout of loans secured by commercial real estate.

II.
HOW THE PROBLEM IS ADDRESSED:
SELF-KNOWLEDGE AND SUCCINCT ANALYSIS ESTABLISHES A GAME PLAN FOR THE FAVORABLE WORKOUT OF EXISTING COMMERCIAL INDEBTEDNESS

The severe recession obviously presents the business owner with challenging issues relating to both complying with obligations under existing financing documents and obtaining extensions of credit. The advice on how to deal with these issues is simple and direct: Self Knowledge combined with Realistic and Succinct Analysis.

The best thing a pressured business owner can do at this juncture is to put into practice the ancient maxim: "Know Thyself." Do not engage in denial of economic realities. Do not panic and delay the tough economic analysis that will eventually need to be made. If it is determined that financial covenants of loan documents are being violated or that problems making loan payments are being experienced or will soon be inevitable, it is essential that preparations are made to proactively and productively reach out to one's banker. Time is of the essence in this process. An analogous case study which illustrates the need to take swift action when there is a sudden downturn in economic activity is the demise of Wachovia, N.A. It has been widely commented that had TARP (Troubled Asset Relief Program) been enacted a number of days earlier, Wachovia might have survived as an independent bank. The short delay in enactment of this legislation rendered Wachovia unable to defend itself against a run on its deposits. The

takeaway from the Wachovia case is that even obtaining forbearance of short duration from one's lender can mean all the difference in preserving the value of one's enterprise.

III.
YOU MAY HAVE MORE INFLUENCE ON YOUR BANKER THAN YOU THINK

While it would be imprudent to imply that there are magic bullets which will make one's banker go away (*he/she will not)*, the banking industry is also under pressure and for many reasons is incentivized to work with a borrower who is prudently managing its economic difficulties. Among the reasons are:

1. Collateral values are in decline. If a bank can "kick the can" down the road, wait for collateral values to improve and avoid negative impacts to its balance sheets, it may do so.

2. The Federal Banking Regulators, in a recent policy statement issued October 30, 2009 (*see* Moses Luski, *Mercy for the Vanquished: Federal Regulators Announce New Policy Statement on "Prudent Commercial Real Estate Loan Workouts"* (February, 2010), *available at* http://www.slk-law.com/articles/default.aspx?id=327) have encouraged banking institutions, in the case where loans are secured by commercial real estate, to engage in loan workouts, even though collateral values have decreased or compliance with financial covenants have deteriorated. Where reasonably prudent repayment terms can be arranged, banks are encouraged to work out existing loans secured by commercial real estate.

3. Commercial bankers may be under deadline pressures at the end of each quarter to evaluate their loan portfolios. If they are surprised by last minute disclosures or reporting at the very end of a quarter, they may be less likely to be predisposed to work with a borrower to restructure a loan. On the other hand, if a borrower proactively reaches out to his banker earlier in the quarter to give a "heads up" of potential restructuring issues, a banker is more likely to work harder to obtain a mutually favorable restructuring.

IV.
PRACTICAL ADVICE

Armed with the general knowledge gained from the discussion above, a borrower seeking to work out a loan with its banker should heed the following practical advice:

- Faithfully comply with all reporting requirements such as the provision of tax returns and financial statements. Failure to comply with these requirements immediately raises a red flag with the bank officer who is responsible for the loan who may in turn flag the loan as potentially troubled.

- Approach your banker with any potential loan issues well before the point of missing payments. Once payments are missed, the bank is less capable of flexibility with respect to a potential loan workout. This is where the term "Know Thyself" has its highest applicability. If business conditions are rapidly deteriorating, prior to reaching the point of no return, the economics of a business should be realistically and dispassionately analyzed.

- Have a management plan ready. Indicate to the banker, as part of a fully documented plan, the changes being made in current business operations to weather the storm and how in the interim the business can support the existing payment schedule or a reduced payment schedule. Alternatively, outline an exit strategy showing what preparations are being made for a sale of the business. The latter alternative may be less realistic in today's economic climate, but may be a viable approach depending on the line of business. This is where the savvy and expertise of the business owner can "buy" some time for the enterprise and possibly be its salvation. In essence, sell the banker with reasonable projections and realistic planned actions, showing the business stands a reasonable chance of weathering the storm.

- Consider consulting with a workout specialist. There are former bankers who consult with businesses and assist them with developing a plan that can be sold to the bank. A capable consultant can inject a very useful level of legitimacy to the workout process in that it establishes a banker-to-banker dialogue which can help your bank more easily justify the proposed workout plan. Also, when dealing with less experienced bank personnel, an experienced consultant can in effect educate the bank on how to structure a solution. An attorney or CPA can also assist with this process. At the minimum, the attorney should be consulted prior to execution of any legal documents to insure the documents properly capture the business terms of the deal and do not overreach to one's detriment. A CPA must be consulted to determine that there are no adverse tax consequences to the proposed workout transaction and to suggest whether there are more tax-efficient means of structuring the transaction.

- Personal expenses should be carefully monitored. If personal expenses and/or withdrawals from the business are out of control, it will not be looked upon favorably.

V.
WORKOUT TERMS:
WHAT TO EXPECT

There are numerous ways to restructure a loan: (a) Interest Only Period; (b) Modified Amortization; (c) Reduced Interest Payment with accrual of shortfall and excess cash flow recapture; (d) Restructure into a "good" A Note and a "bad" B Note; and (e) Negotiated Equity Participation where the bank is permitted to recoup deferred interest and principal payments upon a sale or refinance event. The complexity of some of these structures suggests the need to have a capable consultant or other professional provide advice on which structure is more advantageous.

VI.
WHAT TERMS TO EXPECT ON A REFINANCE

- Since most real property collateral is under water, a loan extension will more than likely be offered rather than a long term refinance. The term of the extension will typically not exceed one year. The interest rate will most likely be increased with a base floor set and a wider spread from the variable base rate. The bank may ask for a fee ranging from 25 basis points to 200 basis points. Obviously, in any given case, the actual terms of the extension will be the result of negotiations based on a unique set of facts so there are no typical terms other than to state it is unlikely that the term will be extended for more than one year.

- For a Real Estate Investment Property, the chances for a longer term refinance increase greatly if the borrower can inject equity to bring down the loan to value and there is sufficient rental income to service the debt.

- For owner occupied real estate, the bank might rely on the cash flow of the business to provide a long term refinance without requiring a reduction in principal.

VII.
A WORD ON LOANS THAT ARE PART OF A COMMERCIAL MORTGAGE BACKED SECURITY (CMBS)

- If your loan is part of a CMBS, in order to trigger workout negotiations it may be necessary to stop loan payments to trigger what is known as a "special servicing transfer event." Once such a special servicing event is triggered, one is put in contact with a servicer that has authority to make decisions on behalf of the owner of the CMBS. **Caution:** *"Please don't try this at home."* Cessation of loan payments should only be made with the advice of legal counsel.

- The typical term for a CMBS loan extension are maintenance of the same interest rate, one year term extension, 5 percent principal reduction and an origination fee of one to two percent. Again, there is no guaranty that these terms may be achieved in a particular case.

VIII.
FINAL TAKEAWAYS

- In order to successfully negotiate a loan workout, a borrower must be able to frankly communicate to the bank what the problems in the business are and what efforts the borrower is taking to mitigate the problems. If the bank sees that the borrower is making significant efforts to help itself, there is a much greater likelihood of bank cooperation.

- Sometimes the pressures facing a particular banking institution are so great that it will have little flexibility in negotiating a workout. Similarly, if a banking institution sells a portfolio loan to a third party, such party may have less interest in negotiations.

- If a business analysis indicates a borrower's business cannot be saved, then it is probably better to know this sooner rather than later and bankruptcy counsel should be consulted.

- If things appear bleak or out of control, remember the mantra: "Know Thyself and It Will Work Out." Facing the storm with a calm focused demeanor will yield a better result than disorganized panic.

Moses Luski is a Partner in Shumaker's Charlotte, North Carolina office whose practice area is commercial real estate.

Moses' Practice Areas:
• Acquisition and Sale of Real Estate
• Real Estate Development
• Leasing
• Real Estate Finance and Lending
• Title Examinations
• Foreclosures/Loan Workouts
• Disposition of REO Portfolios
• Opinion Practice

Moses Luski
First Citizens Bank Building
128 South Tryon Street, Suite 1800
Charlotte, North Carolina 28202-5013
Phone: (704) 375-0057 Ext. 2161
Fax: (704) 332-1197
mluski@slk-law.com
www.slk-law.com
Moses' Biography
All of Shumaker's Practice Areas

Download V-Card