

JAMES E. EGBERT
jegbert@egbertbarnes.com
Admitted in PA, NJ, NY

THOMAS J. BARNES
tbarnes@egbertbarnes.com
Admitted in PA

NEW JERSEY
123 EGG HARBOR ROAD, SUITE 205
SEWELL, NJ 08080
856.227.0900
www.egbertbarnes.com

PENNSYLVANIA
115 WEST AVENUE, SUITE 108
JENKINTOWN, PA 19046
215.886.6600
www.egbertbarnes.com

AN OVERVIEW OF LOAN WORKOUTS

What Is a Loan Workout?

A loan workout (often called a loan modification) is a series of steps taken by a borrower and its lender to resolve the problem of delinquent loan payments. Usually, the result is a modification of the terms of the original loan, done by mutual agreement of the two parties.

It is well-known that today many businesses and individuals are having difficulty making payments on their loans, whether it is a conventional mortgage, a line of credit or some other kind of loan. When a borrower is struggling to generate cash flow, both parties often will be better off if the loan terms can be eased. The borrower can remain in business, and the lender can salvage much more than it would if it pursued a drastic and expensive remedy, like foreclosure or bankruptcy.

Some Features of Loan Workouts

A decrease in the payment amounts: In a standard self-amortizing loan (monthly payment of both principal and interest), typically the outstanding principal balance is reduced, permanently. Or, the borrower and lender can agree to payments based on a smaller amount, while deferring the remainder to a balloon.

An increase in the length of the loan's term: If the term of a self-amortizing loan is increased, the size of the payments will decrease. It makes no sense to shorten the term of an amortizing loan since the larger payment burden does not help the borrower. In some special situations, the parties may agree to a shorter time period, such as where the borrower is paying interest only and the parties want to shorten the time in which a decision must be made by either side. In that case, the lender might agree to forgive the principal balance, reduce it or find some other way to pay it off before going to the courts for help.

A change in ownership or control of the collateral: With a mortgage loan, the lender can simply take a deed from the borrower, who walks away. Often the borrower can bargain for a release from liability for a deficiency (the difference between the value of the real estate and the balance owed to the lender). The lender would sell the property and hopefully get enough to pay the loan off. The same is true for a loan secured by non-real estate assets, like accounts receivable, inventory and personal guarantees. The lender would sell those assets to try and recoup its losses, and the borrower (and the persons giving the guarantees) could be excused. There is a variety of other possible arrangements, including broadening or narrowing the scope of the lender's interest in the collateral while the borrower continues to use it in its business operations.

Broadening or narrowing the lender's options: The lender's legal recourse (its corrective measures or legal redress) is first and foremost against the borrower itself. The borrower's name is on the note and the other loan documents. In addition, many business loans are made with a third-party loan guarantee, such as from the business's owner. In a loan modification, the lender will seek to add any additional sources of guarantees it can, whether from an owner of the business or some third party. Often this can be accomplished in exchanged for a reduction in the loan obligation or a change in the payment structure. The lender can also agree to look to other sources of security, such as hard assets, e.g., another parcel of real estate, a securities portfolio or some other valuable asset that can be easily liquidated if there is a later loan default.

Improving the borrower's and the lender's remedies: The loan documents will list the lender's remedies, including acceleration of the debt, waiver of the borrower's right to trial by jury, foreclosure and where permitted,

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confession of judgment. In exchange for easing loan terms, the lender can insist on new triggers for liability, such as different kinds of events of default, or less restrictive definitions of what constitutes a material adverse change in the borrower's financial condition. The cure periods for defaults can be shortened or lengthened, and what a borrower must do to cure a default can be made more or less demanding. For the borrower's part, attention goes to defining the scope and extent of the lender's potential liability to the borrower, such as for breach of the original loan agreement or in the way negotiations are handled.

Crystallizing and confirming goals, strategies and tactics: Both Borrower and Lender will have much incentive to focus on what they seek to accomplish in the negotiation process. One immediate benefit is to shift the focus away from aggressive action by the lender, or passive resistance by the borrower, and toward the least-expensive way of leaving both parties with one less business problem to worry about.

Some Strategic and Tactical Considerations

- The borrower must convince its lender it can pay off the renegotiated loan. To do that, the borrower needs to show the lender why it would be in the lender's best interest to agree to a workout arrangement.
- The borrower has to alert the lender early. The lender wants and needs to know the borrower is aware of the seriousness of its situation, and that the borrower has a plan to improve its financial picture and keep the loan performing.
- The borrower should be prepared to convince the lender that its strengths go beyond its balance sheet and cash flow statement. Lenders are more likely to go along with a workout plan if non-financial factors are strong within your company. They look at the borrower's management team's honesty, integrity, long-term business planning ability, track record and competency. All play a key role in a lender's decision-making process.

How the Borrower Can Benefit from a Loan Modification

- The borrower can propose a wide variety of forms for the modified loan, and the form of the new deal is limited only by the parties' imagination. Changing the principal amount, length of the term, the interest rate and even the payment method can make a big difference in the borrower's monthly cash flow.
- The borrower can secure a release of its obligations under the loan. If the lender agrees to reduce the principal amount or take the collateral, a formal release will protect the borrower from liability.
- Legal fees, accounting fees and other expenses can be kept to a minimum. Litigation or bankruptcy is very expensive.
- The borrower can avoid the negative publicity that results from being sued or going through receivership or bankruptcy.
- The lender may agree to pay most or all of the costs of restructuring the loan.
- The lender may agree to let the borrower keep its offices, give it the right to buy the collateral at some point for fair market value, or fair market value with a premium, or a right of first refusal with a premium.
- Lender may take collateral in full satisfaction of debt without taking a deficiency judgment give the borrower a release of liability.

How the Lender Can Benefit from a Loan Modification

- A renegotiated loan is much faster than arbitration or litigation, which typically take years to complete.

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- A renegotiated loan is less expensive than a foreclosure resisted by the borrower, or a bankruptcy or a suit against the borrower on the note.
 - The lender can get a release of liability from any lender liability claim the borrower might have and avoid exposure to a future claim.
 - A workout will help protect the value of the collateral, which might suffer from neglect if the borrower was put out of business such as with bankruptcy or foreclosure. The negotiations will bring some order to any ownership transition. The borrower's operations will be as stable as possible.
 - The borrower might agree to waive other defenses it might have under the terms of the original loan documents.
 - Getting a deed in lieu of foreclosure gives the lender immediate possession of the real property and a clean, insurable and marketable title.

For questions or more information on this article, please contact
Tom Barnes at tbarnes@eblawyers.net