The Workout Process: Considerations and Strategies

by

William Michael Barres

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Signature of the Author ______________________
William Michael Barres
Department of Urban Studies and Planning
July 31, 1991

Certified by ______________________
Thomas Steele
Lecturer, Department of Urban Studies and Planning

Accepted by ______________________
Gloria Schuck
Chairperson
Interdepartmental Degree Program in Real Estate Development

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ABSTRACT

As the real estate industry enters into the 1990's, it is experiencing a recession which has already resulted in a large number of loan defaults, especially in the New England region of the country. Unfortunately, many banks and developers have fallen into insolvency because of problem real estate loans. However, both banks and developers are struggling to control the damage of these defaults, through various avenues of loan workout.

In such an environment, it behooves a real estate owner to understand the workout process. This begins by developing an understanding of the regulatory pressures that control and mold the workout policies and procedures of banks. Moreover, the developer must understand the financial and non-financial objectives and constraints of a bank negotiating a workout loan. With this knowledge, the borrower can successfully prepare for future workouts, thus developing beneficial relationships with lenders, thereby facilitating agreement on property and portfolio workout strategies. This thesis will address these considerations and strategies.

Thesis Supervisor: Thomas Steele
Title: Lecturer, Department of Urban Studies and Planning

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CHAPTER ONE

Troubled Real Estate: Genesis of the Problems

The real estate and banking industries are suffering from severe levels of real estate loan defaults, which ultimately lead to workout negotiations. Both banks and their real estate borrowers are struggling to survive through these troubled times. This is especially true in New England. In such an environment, real estate owners are forced to become familiar with the considerations and negotiating strategies necessary to ultimately survive. These considerations and negotiating strategies will be the topic of this thesis.

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As New England enters the 1990's, its' banking community is struggling for its very survival. In the first half of 1990, 36 New England banks with combined assets of 29 billion have failed, of which Bank of New England represents two-thirds. Moreover, the senior vice president of the Federal Reserve Bank of Boston, Thomas Cimeno has predicted that total assets of banks expected to fail in the next twelve months should equal roughly 30 billion. Particularly endangered in the future are New Hampshire and Connecticut banks. "New Hampshire is a basket case....It's pretty well understood that a lot of those companies are insolvent or on the road to insolvencies", Cimeno stated. In Connecticut, ten point four percent of all loans are non-performing. "If New England were one big bank, it would be a problem bank and it would be losing money", said Cimeno. [1]

While the New England banking crisis is severe, it has to be viewed in the context of the problems afflicting our national banking system. Beginning in the early 1980's and continuing until almost the middle of the decade, the real estate industry was served with a potpourri of positive industrial factors. The industry experienced large demand surges because of the entry into the work force of the baby boomers and women.[2] Another key element in the growth of demand for commercial space during this period was a national shift in the economy. The United States changed from being a manufacturing-based to a service-based economy, resulting in a concurrent increase in demand for white-collar commercial space.[3] The real estate industry geared up to meet this demand surge, and especially in New England due to its financial services base.

However, certain changes orchestrated by Congress allowed the real estate industry to over compensate for this increased demand. In response to the complex problems of the banking industry, which were largely due to the flight of depository money from banks to money market accounts, Congress passed the

Garn-St Germain Depository Institutions Act of 1982.[4]

> "This law had two main features. First, it accelerated the deregulation of deposit pricing. By offering a new money market deposit account, commercial banks and thrifts could bid for the deposits they had lost to money market funds. Second, it attempted to revitalize the thrift industry by expanding its charter-in particular by granting additional freedoms to participate in commercial real estate lending and development. But this "new freedom" had a fatal flaw. Banks and thrifts could compete for deposits on price, but the government continued to insure those deposits...The Banks lowered their standards and accepted higher levels of credit risk. Bankers searched for loans that generated big fees, high yields, and were cost-effective to originate-a search that led them to Third World governments, real estate developers and leveraged buyout sponsors."[5]

The result was a huge influx of funds into real estate investment, which because of the need to generate competitive returns on deposits and a competitive lending market, was willing to accept higher levels of risk for potentially higher yielding credits.

These funds were augmented and implemented by a growing real estate industry, which itself had been given additional investment benefits by Congress. In 1981, Congress passed the Economic Recovery Tax Act (ERTA). This Act dramatically changed the Federal Tax Code and increased the attractiveness of real estate investment by: lowering the effective maximum capital gains tax rate; expanding the availability of tax credits; and accelerating depreciation periods.[6] Tax driven syndicates thrived in this environment, resulting in a second major funding source for real estate development, which too often gained its sustenance from passive income tax shelter and not project economic viability. These syndicates--in order to place their money--bid up investment properties far beyond their "cash flow value".[7]

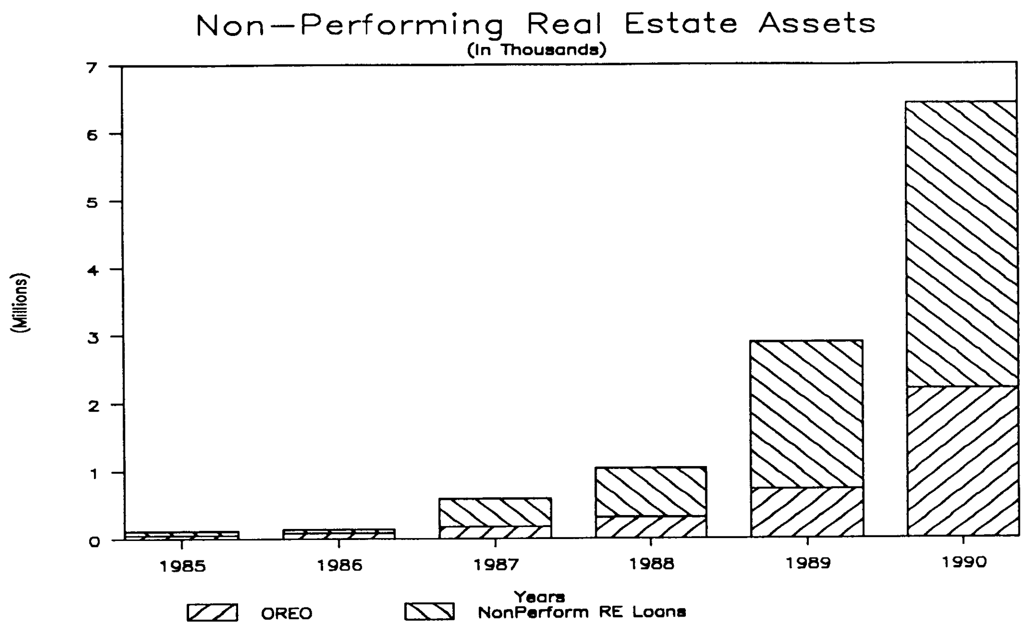
These two factors led to enormous real estate over-supply, created through economically unsound investment practices by both developers and the banks. Because of the lagging characteristics of real estate development and the duration of real estate loans this was not immediately recognized, and therefore these investment practices continued. Even when Congress passed the Tax Reform Act of 1986, which severely curtailed the tax benefits that real estate investors and syndicators had come to rely upon by: increasing the depreciable life of real estate investments; eliminating capital gain exclusions; and implementing passive loss rules[8], this development euphoria continued. Pension funds and foreign investors entered the market and replaced syndicate money.

The sum of these factors resulted in a competitive market where unrealistic bidding rather than demand caused over production and insupportable appreciation. In practically all sectors of the industry there was a huge oversupply of product. For example, "the vacancy rate for downtown office space soared to 17% nationally, up from less than 4% a decade ago and more than double the historic average of roughly 8%."[9] Five Hundred million square feet of vacant office space sits vacant in the United States today.[10]

Rents and property values began to decline precipitously due to this oversupply. This decline in value in turn caused a slowdown in investment by foreign investors, pension funds and banks. Many developers began to experience severe operating cash flow deficiencies which had previously been met by the abundant lending markets. However, concurrently commercial banks were facing newly increased governmental scrutiny by their regulatory agencies. Non-performing loans increased dramatically, causing the banks to curtail lending severely and turn their attention towards their problem real estate loans. The ensuing credit crunch severely impacted the purchase and sale of properties, further decreasing rents and property values, which in turn increased the level of non-performing loans, which increased the strength of the credit crunch, thus resulting in a vicious circle. This phenomenon is commonly called the "real estate death spiral." Needless to say, this environment has severely affected the real estate and banking industries. A rash of developer bankruptcies have occurred and practically all developers and real estate entrepreneurs find themselves wading through a sea of problems. Similarly, banks have suffered greatly from their commitment to real estate. Banking regulators estimate that 200 banks will fail this year alone[11], and possibly 440 through 1992. Moreover, William Seidman, Chairman of the Federal Deposit Insurance Corporation, has said that "the bank insurance fund will be insolvent by year end, due to the projected failure of several large East Coast banks."[12]

As outlined in the opening paragraph, New England banks are having an even worse time of it than the rest of the country. In the fourth quarter of 1990, non-performing real estate assets in New England banks reached almost seven and one-half billion dollars. This figure represents four and one-half percent of total New England bank assets, and almost seventy percent of their total non-performing assets. To extend this observation, six and one-half percent of total New England bank assets are non-performing. As a rule of thumb, bank analysts believe that when a bank reaches a level of ten percent of its assets classified as non-performing, the bank will not be able to weather its' problem loans.[13]

Clearly the storm is not over. Real estate loans less than ninety days past due amounted to almost seven hundred million dollars.[14] This indicates continuing--if not increasing--problems with real estate non-performing loans into the future. The following graph depicts the marked increase in non-performing real estate loans.



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This thesis will concentrate on the New England real estate workout environment, but it is important to understand that workout requirements are not limited to New England, and are, in fact, a national problem: Nationally non-performing real estate loans have increased from ten point six billion in 1985 to thirty-one point three billion in the third quarter of 1990.[16] During the late 1980's, approximately 60% of all new bank lending was in real estate, resulting in a disproportionate exposure in bank loan portfolios. On average, real estate jumped from 25% to 37% of portfolio loans.[17] "The entire American banking system went on a commercial real estate binge in the 1980's, that has brought on a period of worsening troubles now in the early 90's."[18]

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In this environment, where banks are struggling to meet capital reserve requirements and diminish problem real estate loans, developers require a map to guide them through the restructuring of investment portfolios and their debt. To survive, investors need to understand the legal and business avenues available to economically downsize their investment portfolio. Understanding these workout mechanisms is not enough, however. Real estate developers must implement a portfolio workout strategy based on a clear understanding of the driving forces and allowable actions of their unwilling partners--the banks. Within this framework, real estate investors must adopt a flexible strategy which allows for economically viable downsizing. Unfortunately, in some cases, problems are of such a magnitude as to make this impossible.

This thesis will consider the driving forces and allowable actions of banks within the workout environment (Chapters Two and Three). It will then consider the potential avenues that a workout situation may follow (Chapter Four). Finally, within this framework, the author will recommend considerations and strategies necessary to a successful downsizing of a problematic portfolio of real estate investments (Chapter Five).

1. "Failed Banks' Assets Forecast In New England", Lawrence Ingrassia, New York Times, June 7, 1991.

2. "A Look at the Real Estate Cycle", Lawrence S. Bacow, Esq., Professor of Urban Studies and Planning, Director of Center for Real Estate Development, MIT CRED Newsletter, Spring 1991.

3. "A Look at the Real Estate Cycle", Lawrence S. Bacow, Esq., Professor of Urban Studies and Planning, Director of Center for Real Estate Development, MIT CRED Newsletter, Spring 1991.

4. "A Blueprint For Financial Reconstruction", Lowell L. Bryan, Harvard Business Review, May-June 1991.

5. "A Blueprint For Financial Reconstruction", Lowell L. Bryan, Harvard Business Review, May-June 1991.

6. "Principal Reasons for Default and Impact of Financial Structure of Distressed Real Estate", Edward N. McPherson, MIT Thesis, Cambridge, MA.

7. "How Did We Get Into This Mess?!", Dr. Peter Linneman, Director of the Wharton Real Estate Center, University of Pennsylvania.

8. "Principal Reasons for Default and Impact of Financial Structure of Distressed Real Estate", Edward N. McPherson, MIT thesis, Cambridge MA.

9. "Banking Real Estate Miseries", Steve Lohr, New York Times, January 13, 1991.

10. "Banking's Real Estate Miseries", Steve Lohr, New York Times, January 13, 1991.

11. "Banking's Real Estate Miseries", Steve Lohr, New York Times, January 13, 1991.

12. "FDIC Expects To Be Insolvent By Year End", Paulette Thomas, The Wall Street Journal, June 27, 1991.

13. This non-performing loan and asset information was calculated from numbers provided by the Federal Reserve Bank of Boston.

14. This information was provided by the Federal Reserve Bank of Boston.

15. This graph was derived from numbers provided by the Federal Reserve Bank of Boston.

16. "The Capital Crunch and Financial Restructurings", Klatt, Frank and Mack, Real Estate Finance, Vol. 8 No. 1, Spring 1991.

17. "Banking Real Estate Miseries", Steve Lohr, New York Times, January 13, 1991.

18. "Banking Real Estate Miseries", Steve Lohr, New York Times, January 13, 1991.

CHAPTER TWO

The Regulatory Influences of Bank Workout Behavior

In a workout environment such as New England's, a real estate owner approaching a workout scenario with a bank must fully understand the forces which frame and mold the way the bank approaches negotiations. The choice of resolution (see chapter four) which a bank may follow is determined by the bank's policies and procedures, as well as the bank's perception of the workout. It's a given that a bank's negotiating strategy will not be a open book for the borrower. Therefore, insight into the bank's alternatives is an art which must be mastered for a successful workout. This without question is the value of a good workout specialist, because it is an art not easily mastered.[1]

In a troubled banking environment banking regulators directly and indirectly control a bank's policies and procedures. Since the regulatory bodies have the power to determine a bank's policies and procedures, levy fines, change management and even take over a bank, banks develop their business practices with an eye towards escaping the wrath of the regulators. Regulatory actions are always done in order to rein in risk for the bank, and reestablish a strong viable institution. However, it often results in the constraining of a bank's creativity in a workout. This may be a good or bad result, depending on your perspective. In good times regulatory bodies may broadly review a bank in order to insure that there are no gross wrongdoings or unsound business practices. However, in times like these, regulators aggressively scrutinize a bank from the top down and bottom up, paying special attention to areas of risk for the bank. The regulatory bodies greatly influence a bank's dealings with troubled loans, and therefore it behooves a real estate owner to understand the regulatory system, in order to gain insight into a bank's tendencies in a workout negotiation.[2]

There are three main regulatory agencies. The Office of the Comptroller of Currency's (OCC) principal role is regulating national banks. The Federal Deposit Insurance Corporation's (FDIC) primary purpose is the insuring of depository institutions and liquidating insolvent banks, but it also regulates select state chartered banks. The Federal Reserve has three primary roles: central banker, primary regulator of all bank holding companies and regulator of state chartered banks which are members of the federal reserve system. Because these three agencies often overlap when carrying out their regulatory functions, they try to accommodate and coordinate with each other.

Such is the case of the shared national credit review program.

This program targets loan reviews for credits in excess of twenty million dollars, in which two or more banks participate. Teams of bank examiners, with representatives from each agency, are brought together to review these loans and subsequently assign a rating for the loan through a voting mechanism. Each bank which participates in this loan must accept the determined rating and carry the loan on the books to reflect it. This program is of significance since these types of loans usually represent a large proportion of a national bank's loan portfolio. Bank of America, Security Pacific and Wells Fargo were all greatly affected by this program, when loans which they participated in were downgraded through this system, forcing each bank to post large increases in their loan loss reserves.[3]

This type of loan classification scrutiny is usually not mimicked by the agencies on a singular basis. The regulatory agencies tend to examine banks on a broader basis, and then when necessary scrutinize classes of loans more carefully. In New England, this means that real estate loan portfolios are targeted for closer scrutiny.

When a bank examination team enters the bank, it tries to examine the bank from the top down and bottom up. Bank policies and procedures will be reviewed from both perspectives to see if appropriate standards are being set and how well they are communicated to line officers. For real estate lending this analysis includes the effectiveness of the loan review department and how closely the credits are being monitored and accurately rated, the bank's accounting treatment and reserve allocations, and the workout department's policies and procedures. The examiners will also analyze the quality of a banks management information systems to see if the directors are able to financially monitor the bank's investments.

Loan Review and Rating:
The review's main purpose is to gauge a bank's loan risk exposure. As a initial step to determining risk exposure, bank regulators will pick a lending area to do a statistical sampling. If there is no particular area of concern then the examiners will do a global review. From the initial sampling, if there are a large numbers of loan down grades or problems with the system, then the statistical review will be expanded.

For real estate, because of its lagging tendencies[4], early identification of problems is critical. In New England banks this currently entails the close scrutiny of a representative sample of real estate loans. Examiners will open a loan file to review the financial information presented. The examiner through the file information will first determine if the information is sufficient to review the property's underlying fundamentals. The review will consider lease turnover, expense ratios and so on, in an attempt to assess the loss exposure of the credit. This requires up to date property financials and appraisals. Moreover, the examiner will look for information on the guarantor's financial condition. "Too often a banker has not looked at the credit from a global standpoint".[5] The banker does not have a schedule of contingent liabilities or personal financials of the guarantors. In light of this information or a lack thereof and the examiners financial analysis of the underlying fundamentals of the property, the examiner will assign a loan rating to the credit. The different loan ratings are as follows:

Past Credits: These are fundamentally sound loans performing as agreed upon with no evident weaknesses.

Special Mention Loans: These are loans which offer more than the acceptable level of risk and are demonstrating weaknesses. In example, a weakening industry or a credit balance sheet which may be a problem down the road.

Substandard Loans: Loans which have problems which jeopardize the future ability of the borrower to service the debt and remain a performing loan. There is a probable loss, but the loss exposure cannot be defined because of the situation of the loan.

Doubtful: There is a definite material loss, but that cannot be determined because of some problem, such as the loan being stuck in litigation.

Loss: This loan has been determined a full loss for the amount indicated.[6]

While a regulatory agency may not explicitly force a bank to adopt its rating of a loan, it does so implicitly. Regulators are determining whether a bank's loan review is current and realistic, as well as performing a critique of past lending criteria. When a large proportion of a bank's loan ratings are not similar to the examiner's, it indicates that the bank is not sufficiently monitoring their loans. It will also cause the regulators to expand their loan review with the high potential of the regulatory agency taking some form of corrective action.

Accounting Treatment and Loan Loss Allocations:

The regulators will also review a bank's accounting treatment of troubled credits and loan loss allocation policy. When the examiners determine inadequate loan review policies and ratings, this area of consideration will be all the more scrutinized. In addition, the regulators will scrutinize the bank's accounting treatment of non-performing loans more thoroughly.

First the examiners will ascertain whether the bank is properly allocating non-performing and troubled loans on non-accrual status. Performing loans are specified accrual loans where interest payments are deemed income. Banks at times stall the non-accrual specification and loan loss reserve allocation in order to maintain higher income generation. Non-accrual loans apply payments first to replenish the loan loss reserve taken on the loan and then to principal, until such time that the principal balance is deemed supportable by the credit, thereby bringing the loan back into performing status. Subsequent payment amounts can then be deemed income. "If a company shows a large amount of loans more than ninety days delinquent and still accruing interest, the examiner should really ask some questions regarding the bank's reserve practice. Conservative bankers do not have a lot of loans in ninety day accrual, because they are very aggressive in their chargeoffs."[7]

The examiners will also be reviewing the bank's loan loss reserve practices. Loan loss reserves should be allocated for specific anticipated loss on loans as well as allocations based on loan loss migration analysis of loan categories.[8] This reserve and the bank's capital reserves are the offsetting buffer against imminent loan losses, which protects a bank from insolvency. Therefore, regulatory agencies are very concerned in a troubled loan environment with the sufficiency of a bank's capital reserve.[9]

Workout Department Review:

Another area of review during troubled times will be analysis of the effectiveness of the bank's workout departments. At issue will be whether the workout department is receiving proper guidance in their work from the principal officers and directors of the bank. "Sometimes workout departments are on too long a leash and are too creative in their workout restructurings."[10]

From the examination team's work a risk rating will be assigned to the bank, which goes from 1 (very strong) to 5 ("in death throes"). In addition, the regulatory agency may assign a variety of corrective actions in the form of policy and procedure agreements, which tend to correspond with ratings, but not always. These agreements are the regulatory agency's stick which mandates a bank's future operational policies and procedures. Therefore, a bank which wishes to maintain total control of their business needs to avoid any negative reviews by their regulatory agency. In this severe real estate recessionary environment, few banks in New England have been able to fully avoid rating downgrades.

A bank with a one rating is considered very strong and will most probably avoid any corrective agreement, unless there is some unusual condition, such as illegal business practices.

A two rated bank is generally satisfactory, but may have some problems which necessitate a board resolution. This "informal" agreement requires the directors of the bank to sign an agreement with the local regulatory agency stating that they understand that there are specific problems that require specified corrective actions and will take those actions by certain dates and inform the agency of their progress.

A three rated bank has serious weaknesses which need to be addressed, and because of these weaknesses is vulnerable to the changing economic climate. A memorandum of understanding may be placed with this bank. Both the director of the bank and the regulators are signatories of this agreement, which requires corrective action, but is not immediately convertible into an enforceable action against which civil money penalties can be fined.

A four rated bank has weaknesses which must be addressed in order to insure its viability. This rating may require a legal action called a formal agreement. Executed by the bank and the Board of Governors of the Federal Reserve this agreement is enforceable under the law. Under FIRREA, it is convertible to a cease and desist order if violated. The agreement can also for the basis of civil money penalties, which can be as much as a million dollars a day per infraction. Such penalties are not used all that often, but when they are they can be significant.

A five rated bank has severe problems which seriously jeopardize its future. This rating is usually associated with a cease and desist order, such as the one levied against the Bank of New England. This order states that the bank is conducting as unsafe and unsound practice which it must cease doing immediately and into the future. The resulting problems must be corrected, and if the bank does not follow the stipulations of this agreement, then the company will be subject to fines and the directors may be held personally liable for any losses the company suffers. "This action is very heavy and it is something that is not entered into lightly."[11]

There are a variety of other actions a regulatory agency may take, including the removal of bank director and officers, as well as the removal of FDIC insurance. Regulators try not to use a bigger stick than is necessary when placing corrective actions, and currently have latitude in choosing the method and type of corrective agreements. However, there is presently proposed legislation in front of Congressional banking committees which would mandate the placing of certain agreements with the different bank ratings.[12]

Needless to say, the regulatory agencies, and their guidelines have a strong impact on the business practices of a bank. Therefore, it is of paramount importance for a real estate owner involved in a workout to understand the bank's regulatory relationship. By understanding how his loan is classified, a borrower can sense the negotiating latitude of the bank, as well as help provide the information which will minimize regulatory scrutiny of the specific loan.

1. Anonymous Interviewee, Workout Specialist, General Partner, June 16, 1991.

2. These two preceding chapters and the whole section concerning the regulatory bodies and their practices was developed from an interview with Claire Desjardins, Asst. Vice President, Federal Reserve Bank of Boston. Unless otherwise specified, in the information in this chapter was derived from the aforementioned interview.

3. "Gray Skies for California Banks", Richard W. Stevenson, New York Times, July 8, 1991.

4. A large proportion of a bank's real estate loans are construction and miniperm loans. Both these type of loans usually include an interest reserve which the bank retains for servicing of the loan, since the developer may not have the financial capacity to do so during construction or start-up. Therefore, when a project financed by these methods goes into default, the assumption is that the problems which caused default have been there for quite some time. These problems, however, had a lagging exposure to the bank, because of the interest reserves, which kept the loans performing.

5. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

6. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

7. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

8. The examiner is looking for "a discipline and thought process" regarding troubled loan areas. Therefore they will expect a bank to have used "migration" analysis to determine the rate at which troubled properties migrate through the risk categories from troubled to loss, and subsequently adding to their loan loss reserves in anticipation of their findings, and even adding additional amounts for safety sake. Therefore, a conservative bank will have fewer specific chargeoffs on their larger credits, since they have already run the losses through their income statement.

9. Regulators will look at three capital ratios to get a sense of capital adequacy. Criticized Loans (special mention and transfer problems of international loans) vs. capital reserve and loan loss reserve. Gross Classified Loans (substandard, doubtful and loss) vs. capital reserve and loan loss reserve. Weighted Classified Loans (100% of loss, 50% of doubtful and 20% of substandard) vs. capital

reserve and loan loss reserve. If the weighted classified ratio is 80-90% then there is little chance of continued viability for the institution. Similarly, if the gross classified ratio is 150-200% there are serious problems for the bank.

10. Claire M. Desjardins, Assistant Vice President, Federal Reserve Bank of Boston, July 9, 1991.

11. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

12. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

CHAPTER THREE

Understanding The Lender In Workout Situations

As stated in chapter two, there is a strong regulatory influence in the way a bank will deal with workout loans, since banks operate in a manner which is mindful of their regulatory agency's expectations and powers. Nevertheless, depending on a bank's policies, procedures, personnel and structure, a bank may react in varying ways to this regulatory pressure. Banks may not always act as regulatory agencies would like in a workout situation.

When entering a workout scenario, a borrower must understand the progression of a troubled loan within a bank's structure, and how a bank views loans during this progression. Moreover, at that critical point when the bank is weighing the viability of pursuing workout negotiations opposed to gaining title to the property, the developer must fully understand what issues the bank is weighing to persuade the bank of the borrower's preferred avenue of resolution. In this chapter, these lender considerations will be addressed in much the way a typical commercial bank would address them.

The Progression of a Troubled Loan:

The initial approval of a loan is sponsored by a lending officer, who is responsible for assembling appropriate information for analyzing the credit. When the loan is approved it is assigned a particular risk assessment by the lending officer and his loan approval committee.[1] This rating system is often very similar to the bank's regulatory agency's, but the bank may expand it for more precise rating, and in fact is encouraged to do so.[2] During the life of the loan, the account officer is responsible for altering the credit rating as circumstances change; so, as a credit deteriorates the rating should drop.[3]

However, at times a lending officer may not follow these procedures in a timely manner. Sometimes a real estate lending department or officer may be wary of downgrading a credit and loosing control of the loan to the workout department, especially when the customer is considered valuable to the department's future business. Frequently, in the beginning of a cycle, when the loan officer is not aware of the extent of future industry problems, he will try to find a way to keep the loan, and nurse it back to health. However, if a loan officer is a quality credit person, he is more concerned with the credit rating than keeping the client, so that he will open dialogue with the appropriate senior officers when the credit becomes questionable.[4]

Aware of these inefficiencies or conflicts of interest, banks often have an independent loan review department. The independent nature of the loan review department allows for objective analysis. Usually on a quarterly basis, this department reviews loans over a certain dollar level, and less frequently for loans which fall under this bench mark. If necessary, they may downgrade loans and bring them to the attention of the workout department. In this way, even loans which are still making payments, may be downgraded and brought to the attention of workout specialists for preventive monitoring and change.[5]

To the extent that the credit becomes marginal, the workout department will assist the loan officer with addressing the problems in a remedial fashion. Similarly, they will be considering protective measures for the bank.[6] Typically, a recasting of the mortgage does not occur in the lending department, unless the customer carries some significant element of political weight within the bank, and the bank is not being forced to proactively take action by the regulators. During the initial phase of default, there may be a crescendo of discussions towards a quickly applied credit resolution, ending when the loan reaches 90 days past due. At this point, the bank by regulation, must show the credit as non-performing, thereby flagging the credit for the regulators to see. Moreover the credit most probably will be moved to the workout department.[7]

"When a workout department gets a troubled loan, the department really needs to go back to the basics, and start from scratch, in order to gain an understanding of exactly where the credit is... basically you need to review the financial and legal picture."[8] The workout officer will thoroughly review the legal documents, the lending officer's prior oral and written correspondence--determining whether the bank is exposed to lender liability suits, and the property's conditions--financial and otherwise. With the many avenues a workout can take, "the workout officer needs to understand the cards that have been dealt".[9]

Legal Document Review:

The first job of the workout officer is to ascertain the condition of the title. "If a loan has been around for several years..., it is often assumed that the security or UCCs (Universal Commercial Codes) were filed properly and that they accurately describe the collateral that you think you have, this may not be the case. The workout officer needs to understand the loan documents and terms, as well as subordination agreements."[10] In addition, the title must be reviewed for recent tax, judgement and mechanics liens. When creditors have filed against the property, the officer needs to ascertain when their preference period ends. Finally, the workout officer must check as to whether the title insurance is sufficient and in effect.[11]

Another area of legal documentation import are guarantees. At times, the actual guarantees which were supposed to accompany the loan may have been altered or negotiated away by the lending officer during closing, as well as other legal rights of the bank.[12] Moreover, the legal document may not have been properly filed or executed.

Loan documents vary greatly and frequently omit essential provisions in case of borrower default or diminish the lender's rights, therefore the workout officer must comprehensively review these documents. For instance, the FNMA mortgage allows the borrower to reinstate a defaulted mortgage till the time of judgement. It also requires the lender to post a detailed default notice to the borrower, thirty days prior to acceleration, thereby extending the foreclosure process. Other standard forms inadequately address such issues as the payment of penalties and legal fees, as well as including a due on sale clause.[13]

Oral and Written Correspondence Review:

Concurrent to the documentation review, the workout officer will work with the lending officer to review any oral or written commitments made by either the lender or borrower, especially those commitments made in the last ninety days or so. "The workout officer shouldn't do anything which is contrary to any prior commitments by the bank".[14] Through the documentation and correspondence review, the workout officer wishes to assess the lender liability exposure of the bank. "Lender liability is a catch all category which has become popular because it is easily threatened, although very few cases have any substance. Most cases stem from allegations of inequitable conduct of the bank which is prejudicial to the borrower or the failure to do something promised." [15] Despite its poor success ratio, lender liability is one of the few negotiation axes a borrower may wield in his defense, the threat of which may force the lender to renegotiate its stance. At the very least, an actual suit buys time for the borrower while costing the bank time and money. At the most, it may result in a liability penalty levied against the lender and awarded to the borrower. "Typically, lender liability claims are more in the nature of attempts to offset the debt. It is not coincidence that the bank may sue for one half million and the lender liability claim is about the same figure."[16]

"Lender liability is probably at its peak when you have a construction loan: when the loan is out of balance and not fully drawn. The workout officer wants to make sure that there have been no oral or implied commitments in regards to the extent the loan can go out of balance."[17] Other frequent lender liability allegations follow: "failure to issue a written loan commitment; failure to comply with or attempt to terminate a loan commitment; undue control over the debtor resulting in the lender's responsibility for the debtor's debts; being the borrower's partner; failure to disburse a loan according to its commitment; breach of fiduciary duty; failure to act in good faith; interference with the debtor's business; inadequately controlling debtor's taxes; attempting to improve its position prior to bankruptcy filing; being guilty of fraud, duress or tortious interference; misuse of loan collateral; usury; environmental liability; and, securities law violations."[18] As can be seen, lender liability can take a myriad of forms -- some more legitimate than others. The bank's exposure to such suits may sway a workout officer to forgo the bank's foreclosure rights for a temporary workout alternative, in exchange for the borrower's waiver to such claims.

Financial and Environmental Review:

While conducting this initial due diligence, the workout officer will also try to understand the financial fundamentals of the property. This will necessitate an analysis of the property's income statement and most recent appraisal to derive a current projected value for the property. If the bank's credit information is old, the officer may request a new appraisal or updated financial information for the property from the borrower.

Additionally, new personal financial statements of the borrower and his portfolio of properties may be requested, thereby gaining a testament to the borrower's financial capacity to honor his guarantees. Moreover, the workout officer needs to gain a global understanding of the liquidity of the developer through this information, in order to understand whether the borrower has the ability to withstand the current downturn.[19]

An environmental review of the property will also be considered when called for, because the workout officer suspects some type of contamination of the property.

> "In most instances, before a bank forecloses these days, they take a tremendous amount of care to assure themselves that there is no hazardous waste that exists on the site...the bank will hire specialist to scrutinize the property, to determine the existence of hazardous waste. To the extent that any waste exists on the site and the bank takes possession or title of it...then it becomes liable for the hazardous waste whether or not it had anything to do with dumping the waste."[20]

Since an environmentally contaminated property can represent huge liability for a bank, workout officers rarely dismiss a careful environmental review.

These are the key issues of consideration that a workout officer will investigate when completing his initial due diligence indoctrination of a troubled credit. Armed with this knowledge, the initial meetings with the borrower will commence. The bank will be confronted with a new set of considerations, which will determine whether it chooses to foreclose on the property or restructure the loan. These following issues do not necessarily adhere to the timeline progression presented here, to some extent they may be reviewed in the workout officer's initial research. Nevertheless, after indoctrination with the troubled credit, the workout officer will focus on the bank's financial and non-financial objectives, as well as defining constraints which may affect the foreclosure or workout decision.

Financial Objectives:

Possibly the most important objective of the bank is limiting non-performing asset exposure, from both a specific and global viewpoint. Therefore, workout officers approach a troubled loan workout with the goal of making the credit "asset good".

> "One of the principle determining factors as to what the bank may or may not do is whether or not the loan on the books can be treated as a performing loan or non-performing loan. To the extent that the income doesn't service the loan it becomes a very unattractive item on the bank's

balance sheet. The bank has much greater incentive to take a precipitous action with the borrower to collect its money, sell the building and liquidate the loan. Even though there is a higher prospect that there might be a short term loss, the bank may in some instances rather have the certainty of the cash in hand and eliminate the drain of a non-performing asset, rather then sit and wait with the borrower hoping that the market may turn around in three years, for all the money that's owed."[21]

When the cash flow and guarantees are not sufficient for maintaining the credit on performing status, the banker may seek a cash paydown or cross collateralize the debt to make it asset good.

> "Normally in a restructure, if you can achieve it at all, you are going to try to get some type of cash paydown, if you can't the key is to try to become asset good. If you can't achieve it through the existing property--because obviously in this market property values are falling--then the next place a banker is going to look is to other properties in the form of cross collateralization (through second mortgages), partnership interests or whatever else is available."[22]

The characterization of loans is an area in which the regulators wield their influence, since ultimately they will rule the future accounting treatment of a restructured loan, thereby determining whether a loan is a productive asset or a negative drag on income.

> Regulators indirectly have an influence on the workout, because when we are structuring the deal with the borrower, we want to be mindful of not only what the economic impact on the project will be, but we also want to be mindful of how that deal will be accounted for by the bank and how the regulators will insist that the bank account for the loan, after we strike a deal. We are striving to maintain performing assets and we know in the back of our mind what the regulators expect in order to be able to characterize the loan as a performing asset. When you are structuring a deal you are at all times mindful of the elements of a performing loan, and you do your best to get a deal which would be characterized under those guidelines performing, so that the examiners will feel comfortable with it.[23]

Another financial objective of a bank involved in a loan restructuring is the productive safety of any new money devoted to the workout. Frequently, in a workout or mortgage recast the property will need an infusion of additional money (this is especially true for construction loans), with the only viable source being the workout lender. In such scenarios the bank's primary question will be whether this additional money adds value to the probability of the lender being made whole, or at a least lessens the projected loss of the bank. In addition, the bank will demand current interest on the new money, legal assurance that it will have priority over junior creditors, and economic certainty that the new money will be repaid. This may require negotiations with not only the borrower, but also subordination agreements with the other creditors.[24]

Finally, the workout officer must weigh the financial risks of the bank's potential avenues of resolution, and choose the alternative with the proper risk-return characteristics. When considering the prospects of a successful workout program, a bank must always weigh the financial risk of any proposed restructuring. With the uncertainty of a deteriorating market, the bank usually will follow the maxim: "a bird in the hand is better than two in the bush". A lender must look for a plan with a high probability of success, thereby avoiding the primary financial risk of the bank, that the future settlement of the workout plan is less than the present value of the property to the bank. Therefore, as a bank enters a workout agreement, it will wish to insulate itself from the loss of new money, further deterioration of the value of the project, loss of interest and security impairment.[25]

Non-Financial Objectives:

A primary non-financial objective for a bank is to minimize the time it takes to find a resolution to a workout--whether it is a financial restructuring or a foreclosure action. In a very real sense, time is money for the bank in terms of interest, legal, opportunity and resource costs. Therefore, the bank will view potential workouts in the context of time.

> The bank strives for some comfort that it is not going to be in the same place that it is today, six months from now. If that's the case--if it is not making any progress in the workout, then there in no reason why you shouldn't just pursue your remedies as specified under the loan documents now. The objective is to get an improving situation, while at the same time giving the developer some time to bridge the temporary period of impairment.[26]

The minimum amount of time is especially critical when the bank is faced with some sort of legal entanglement, such as borrower or partnership bankruptcy and a lender liability suit.

Defining Constraints:

Certainly on of the prime considerations of a lender when deciding between gaining control of the property and restructuring the loan is whether the lender can successfully work with the borrower in the workout. This entails a favorable assessment of the borrower's management capabilities, commitment to the workout and predilection towards honoring his workout commitments. In essence, the bank needs to know that the continuation of the borrower-lender relationship has a beneficial impact on solving the bank's problems with the loan.

When a bank enters a workout negotiation, it will look at the borrower's management capacity, to see if the project's problems are a result of the company or the market. This is a key element in deciding whether to ride the project out or foreclose.[27] The borrower's management abilities must add more value to the workout plan than a third party management firm's. Otherwise it may benefit the bank to pursue foreclosure and hire a third party management firm to operate the property until the bank can sell it.

The bank will also want to gauge the borrower's commitment to a successful workout resolution. One way this is manifested is by the borrower's cooperation in providing the bank with the necessary financial information on the property, the borrower's other properties, the guarantors and any other information that the lender may need to make completely informed decisions on the viability of a workout. When the borrower is not forthcoming with information, the workout officer is unable to prudently make a commitment to the project and can only make negative assumptions, which lead the bank towards a foreclosure action.

Moreover, the bank is looking for a proactive attitude towards restructuring negotiations. As one workout officer said:

> What I would say to most borrowers is that they shouldn't down play how important it is to -- on the outside at least -- work with the banker. The individuals who come in and show an unwillingness from the beginning to negotiate, and try to work with the bank with some give and take, end up hurting themselves in the long run, because they create this animosity that in some cases is reflected in the terms that are being offered.[28]

In order to assure the borrower's commitment to the project, banks usually try to maintain and even increase their guarantees and collateral.

> Most important to the banker are the guarantees on the debt--that is you are going to want the developer to be behind whatever restructure you are

> working on one hundred percent, because they are the person closest to the property. They are the ones who are most likely going to work out a deal -- to find tenants, to get the tenant fit up at the proper price, to manage the project, etc. So you are going to want -- in essence -- their feet to the fire throughout the term so that they know if they don't perform that there is a consequence -- that is that their name and their personal assets are on the line.[29]

Finally, when assessing the benefit of continuing to work with the borrower, the bank will want to determine whether the borrower will honor his prior and new commitments.

> A workout officer wants a familiarity with the history of the situation, meet the people, understand the principals' characters, personalities, temperaments and their desire to stay with the project. To some degree if possible measure their integrity, although this is very difficult to do, until a situation gets into a push or shove condition. Will they stand behind their commitment and promises?[30]

This is a key ingredient to the bank's willingness to work with a borrower, towards a joint resolution of the property's problems.

There are two other constraints which are of defining magnitude, but are themselves unrelated. The first is the potential of sale if the bank takes back the property. It does no good for the bank, if they take back the property into OREO and can not sell it, and thus still maintain the asset on their books as non-performing status. This is especially true when the third party management is inferior to the prior owners'. As one workout officer stated: " the foreclosure decision has a lot to do with the property itself and what the bank thinks of the prospect of sale is."

The final defining constraint is the functional workout capacity of the loan's participating group of banks, if indeed it has one. Participation agreements are agreements between banks which share in the underwriting of a loan. The "agent" bank is usually responsible for the total servicing of the loan and customer relations, while the participating bank(s) is a silent financial partner. The participation agreement can provide for different levels of workout powers between the agent and participant banks. Some may have a weighted voting system, in which key workout decisions are voted upon. Others may weight the powers to one side. These agreements can become a problematic factor in the viability of a workout, since the participating banks may have extremely different workout agendas than the agent bank.[31] As one workout officer stated:

> Participations are my worst nightmare. I would much prefer to work on a multi-loan direct relationship, where I had all the debt and I had the borrower across the table from me, then to try to get seven banks to agree on a course of action, all of which recognize different levels of problems with the loan, take different tacts in terms of chargeoffs and non-performing levels. This is especially true with foreign banks which often have no workout experience. [32]

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For the borrower attempting to restructure a workout property's debt, success necessitates understanding a bank's driving forces, objectives and constraints. A real estate owner must also understand a bank's policies and procedures, and how they change as a troubled loan progresses through the bank. This knowledge allows the developer to present his company, the property and other critical information from a legitimately positive viewpoint -- the bank's viewpoint. As one workout specialist advocates, perception is the key to successful workouts. Perception of what the bank and workout officer are looking for to make a positive response, and the resulting perception of the viability of the workout that the bank ultimately gets through the workout officer's relationship with a well prepared borrower.[33]

1. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

2. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

3. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

4. Bill Reilley, Former Workout Officer with the Bank of New England, June 20, 1991.

5. Bill Reilley, Former Workout Officer for the Bank of New England, June 20, 1991.

6. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

7. Bill Reilley, Former Workout Officer for the Bank of New England, June 20, 1991.

8. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

9. Bill Reilley, Former Workout Officer with the Bank of New England, June 20, 1991.

10. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

11. "Lender Liability: Minimizing Risk in Resolving Troubled Loans", David B. Eizenman, Real Estate Finance, Vol. 7 No. 2, Summer 1990.

12. Bill Reilley, Former Workout Officer, Bank of New England, June 20, 1991.

13. "A Lender's Guide to Mortgage Foreclosure: A New Look", Bruce J. Berman, Real Estate Review, Vol. 18 No. 1, Spring 1988.

14. Bill Reilley, Former Workout Officer of the Bank of New England, June 20, 1991.

15. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

16. Mark Cahill, Esq., Choate, Hall and Stuart, June 25, 1991.

17. Bill Reilley, Former Workout Officer of the Bank of New England, June 20, 1991.

18. "Risks of Lender Liability in Credit Decisions", Stuart M. Saft, The Real Estate Finance Journal, Summer 1991.

19. Bill Reilley, Former Workout Officer of the Bank of New England, June 1991.

20. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

21. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

22. Kim Meader, Senior Vice President, Classified Loans, Bank of New England, June 26, 1991.

23. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

24. "A Borrower's Guide to Real Estate Loan Workouts", Lesser and Klug, Real Estate Finance, Vol. 7 No. 2, Summer 1990.

25. "A Borrower's Guide to Real Estate Loan Workouts", Lesser and Klug, Real Estate Finance, Vol. 7 No. 2, Summer 1990.

26. Kim Meader, Senior Vice President, Classified Loans, Bank of New England, June 26, 1991.

27. Bill Reilley, Former Workout Officer of the Bank of New England, June 20, 1991.

28. Kim Meader, Senior Vice President, Classified Loans, Bank of New England, June 26, 1991.

29. Kim Meader, Senior Vice President, Bank of New England, June 26, 1991.

30. Bob Kelliher, Vice President, Classified Loans, State Street Bank, June 26, 1991.

31. Kim Meader, Senior Vice President, Classified Loans, Bank of New England, June 26, 1991.

32. Kim Meader, Senior Vice President, Classified Loans, Bank of New England, June 26, 1991.

33. Anonymous Interviewee, Workout Specialist, General Partner, June 16, 1991.

CHAPTER FOUR

Potential Workout Alternatives

Because of the prevalence of workouts in the early 1990's, many banks have markedly increased their workout or "classified loan" departments, frequently importing grizzled workout specialists from the Texas and Arizona markets. With a higher degree of professionalism as well as an increased personnel pool, banks have streamlined their workout capabilities. Moreover, with the close scrutiny of the bank regulators, commercial banks and thrifts have focused their attention on non-earning assets, setting clear capital goals for the bank, by which the their workout officers set their agendas.[1] The result of these factors is that most banks are well versed in their workout alternatives and rights.

For the developer this means a quicker resolution of a workout property, especially when dealing with larger commercial banks. In the beginning of this real estate recession, many workouts were put on hold because banks had larger workout problems or a lack of workout acumen. This often gave a developer the time latitude in the workout to attempt new marketing strategies, while the loan remained in default and on the bank's workout docket.[2]

However, as banks became indoctrinated with their workout alternatives and rights, and increased staffs to handle workloads, this latitude has for the most part vanished. In today's market, when a property reaches the attention of a bank's classified loan department, a developer can expect a timely disposition following one of four resolution avenues: 1). Foreclosure, 2). Friendly Foreclosure or Deed in Lieu of Foreclosure, 3). Restructuring of the Loan, 4). White Knight Acquisition of the Project. The avenue of pure foreclosure is initiated and controlled by the lender, while friendly foreclosure, deed in lieu of foreclosure, restructuring of the loan and white knight acquisition require joint commitment. A fifth alternative--chapter eleven--is controlled by the borrower, and is often used when the borrower is trying to stop the foreclosure action.

This chapter will discuss the four avenues of resolution which are controlled by the lender or require lender acquiescence, as well as the primary borrower controlled resolution -- chapter eleven. In the case of loan restructuring the loan modification issues will be reviewed, as well as other lender and borrower considerations, since these latter issues are often key parts of the total agreement, without which either side might not agree to the restructuring.

Lender Controlled Avenues of Resolution

FORECLOSURE:

Foreclosure is an alternative available to banks and other lien holders, when an acceptable resolution can not be found to rectify a borrower's default. Rarely does a lender rush to foreclose when a mortgagor candidly communicates with the mortgagee regarding the default and offers a realistic plan to cure the default. Foreclosure actions are costly and often time consuming. However, at times like these, where there is no foreseeable quick rebound of the real estate market, banks often initiate the action quickly, and then in the time before sale fully consider their workout alternatives.[3] Foreclosure proceedings are governed by state law, and vary significantly from state to state. Therefore, it behooves a mortgagor to understand the different foreclosure actions available in the state of their holdings, as well as their corresponding rights and defenses under such proceedings. There are three major types of foreclosure: non-judicial; judicial; and strict.

Non-Judicial Foreclosure:

In some jurisdictions real estate is financed by a deed of trust, rather than a mortgage. Alabama, Arkansas, California, Colorado, District of Columbia, Delaware, Illinois, Mississippi, Missouri, Nevada, New Mexico, Tennessee, Texas, Utah, Virginia and West Virginia are states where a Deed of Trust is common. However, this list is not complete since other states may witness this form of ownership in smaller degrees, although most other states have ruled that a deed in trust is in essence a mortgage, and therefore must go through normal court foreclosure proceedings. Three parties are involved with the deed of trust: the borrower, lender and trustee. Upon purchase of the property, the borrower conveys to the trustee the deed and a trust agreement, which stipulates the security arrangement and gives the trustee power of sale upon default.[4]

For the lender, a non-judicial foreclosure usually requires far less time and subsequent expense. The foreclosure is controlled by the trust agreement and statutory law. Typically the trustee must first give notice of default to the owner for a period of fifteen to thirty days, in order to afford the borrower time to correct the default. Next public notice through the newspaper must be made for a specified number of times, during a specified time period. After completing the statutory requirements of such a foreclosure, the trustee may conduct a private sale similar to the sale conducted in a judicial foreclosure.[5]

Judicial Foreclosure:

Judicial foreclosure occurs in states which use a mortgage deed and note. The mortgagee initiates the foreclosure by filing a lawsuit alleging default by the mortgagor. Along with the suit the bank must satisfy applicable procedures, which vary from state to state. The bank should also file an affidavit, which states that none of the defendants are in the active military, thus satisfying the Soldiers and Sailors Civil Relief Act of 1941.[6] Upon satisfying the applicable procedures, the court will enter a judgement, setting a foreclosure sale and final judgement date and naming an officer of the court to conduct the sale of the property. In the interim, the foreclosure sale will be advertised to the public in newspapers a specified number of times.

Upon final judgement the property will be sold by public auction, often times on the courthouse steps. In some cases, if the sale price is significantly below a fair market price, the borrower may request that the auction sale be cancelled and a new auction sale attempted or a strict foreclosure implemented. However, the borrower must produce a legitimate reason for the court to take such an action, such as a conspiracy to limit bidding or a collusive sale. The cost for a new sale will be borne by the mortgagor. This foreclosure process at its' quickest will take three months. If a foreclosure defense is raised, it must be dispensed of by summary judgement.[7] Depending on the legitimacy of these defenses, the foreclosure action can be delayed for years, causing the bank to suffer extreme legal, forgone interest and time costs.[8]

Strict Foreclosure:

Foreclosure by strict follows many of the same procedures as that of foreclosure by sale. However, the value of the property is determined by a certified expert, rather than by sale. If the determined value is unsatisfactory to the owner, he may petition the court for a foreclosure by sale. The foreclosure occurs through a series of "law dates" which run in reverse lien priority. On each law date the specified lien holder has the exclusive "right to redeem" by paying a judgement extinguishing all other lien holders' right of redemption. If the lien holder chooses not to redeem, the creditor looses security in the property. If no junior creditor redeems the first mortgagor gets clear title.[9]

General Foreclosure Issues:

Right To Receiver:

Frequently loan documents give the mortgagee the right to appoint a receiver to manage the property and its' financial returns when default occurs. However, since a foreclosure court is a court of equity this is not a forgone right, since in essence the appointment of a receiver takes away the benefits of ownership from the mortgagor. The bank must show reason why a receiver should be granted control. In example, that the borrower is not properly maintaining the project or siphoning cash flow which should be used to pay mortgage costs.[10]

Foreclosure Funds Dispersal and Deficiency Judgments:

When a foreclosure action is consummated the resulting funds are dispersed in order of lien priority, with any remaining proceeds awarded to the prior owner. In cases where the foreclosure proceeds are not sufficient to make the lien holders whole, those creditors sue for a deficiency judgement. This allows a creditor awarded a deficiency judgement to attach and execute their legal remedies on other properties owned by the mortgagor. Some states provide that certain amounts of personal property and equity in a primary residence shall be excluded from the seizure and sale rights of a deficiency judgement holder.[11]

Redemption Rights:

During the course of the foreclosure and for a period thereafter in certain states, the borrower has the right to pay the full amount of debt, interest and other costs due the mortgagee to redeem ownership. The "equity of redemption" refers to the borrower's right to cure default from the time of default until foreclosure proceedings are begun. "Statutory redemption" is the right to redeem ownership for a specified period (6-12 months) after the foreclosure sale, and is allowed in only certain states.[12]

Jointly Controlled Avenues of Resolution

There are three workout avenues which require the commitment of both the lender and borrower. Friendly foreclosure and deed in lieu of foreclosure accomplish the transferral of title to the lender, the choice of which is dependent on the debt structure of the property. Restructuring of the loan necessitates a consensual agreement of both parties, while a white knight acquisition requires, at the minimum, the acquiescence of the lender.

FRIENDLY FORECLOSURE:

A "friendly foreclosure" follows the statutory requirements of foreclosure, but usually is expedited and simplified because of the borrower's cooperation in the foreclosure proceeding. By agreeing to forgo its' defenses and consenting to judgement in a foreclosure, the borrower usually saves the creditor time and money. These benefits are augmented by the borrower offering transitional assistance by providing property information, fully assigning property rights, and relinquishing all lender liability claims[13] . A friendly foreclosure is used in conveyance of title instead of a deed in lieu of foreclosure when there are junior lien holders on the property, which need to be eliminated through the foreclosure process, in order for the first mortgage holder to gain clear title.[14]

DEED IN LIEU OF FORECLOSURE:

A deed in lieu of foreclosure is the voluntary conveyance of title in cancellation of the mortgage. This process avoids the court process of foreclosure and thereby affords the mortgagee time and interest savings. In return for voluntary conveyance of the title by either foreclosure or deed in lieu, the borrower usually obtains a waiver of deficiency in the form of a covenant not to sue, which will be exchanged by both parties. A first mortgage holder will pursue this option when there are no junior lien holders, which otherwise would not be eliminated in the process. Hypothetically, a junior lien holder could seek acquisition of title through this process, assuming the existing senior debt. However, this requires a mortgagor who prefers ownership of the property over the settlement received in a foreclosure sale.[15]

RESTRUCTURING OF THE LOAN:

The actual restructuring of a loan involves three potential avenues of change: interest modification, amortization rate change, and decreases in the amount owed. These alternatives are not exclusive of each other and in fact are usually used in some combination. Additionally, along with these are other items of negotiation, which frequently are more heatedly negotiated than the loan terms. Some of the key items the bank will seek to obtain are: minimal performance standards, release of future liability claims, additional collateralization, lien priority, and possibly participation in future profits. The borrower will seek to obtain a forbearance agreement, minimize personal liability, structure an economically valuable interest in the property, possibly acquire additional funding commitments, and maintain reputation.

Interest Modification:

The modification of the face interest rate of the mortgage can take many forms. The simplest change is a straight reduction of interest rate. However, this method is not usually favored by the bank, especially when junior mortgages exist on the property.[16] Frequently, an interest pay rate will be established with the difference between the pay rate and face rate being accrued and added to the principal. The borrower and the lender determine a level of current interest that the project can safely support, with any additional interest being accrued till the retirement of the debt or some predetermined date. In this type of agreement, the bank may negotiate for the right to charge and accrue interest on the deferred interest itself. The deferred interest may be added to the principal balance resulting in a negative amortization mortgage or retain its character as interest. In the former case the deferred interest will automatically bear interest, unless otherwise agreed upon.[17]

A popular derivation of this type of interest modification is the "cash flow mortgage". In this type of mortgage, the borrower pays whatever the net cash flow of the property is to the lender with the difference between the payment and the face rate of the mortgage being accrued. Within this net cash flow calculation is usually some adequate management fee for the borrower, so that borrower liquidity can be maintained. This type of agreement allows for fluctuations of cash flow, and thereby protects the workout agreement from further defaults because of payment shortfalls. Similarly it provides for the maintenance of the property, since the borrower will not be inclined to defer necessary maintenance to make a mortgage payment.[18] For both parties, once the general agreement has been reached, the definition of "cash flow" becomes of paramount importance, since it must be a manageable and fair agreement for a successful workout. At issue will be borrower compensation, lender compensation and guaranteed property maintenance.[19]

Amortization Rate Change:

In addition to interest rate modification, the workout can include a change in amortization rate by increasing the amortization years or relinquishing the amortization feature of the mortgage altogether, thereby resulting in a interest only loan.

Decrease in the Amount Owed:

Between the time that a loan goes into default and the two parties come to a workout agreement, large amounts of unpaid interest and late penalties often accumulate. These elements of a borrowers' debt are frequently negotiated in the workout forum. Moreover, even the principal debt may be negotiated down, when market value of the project is less than the existing debt. Banks may consent to such an agreement in order to provide a financial inducement to a borrower, who may bring special management capabilities necessary to the project. However, it should be noted that this is rarely agreed to by the lender.

Additional Loan Restructuring Issues:

Lender Considerations:

As aforementioned, when such a debt recasting occurs other items of importance will be negotiated by both the lender and borrower. The bank will be concerned with structuring an agreement which does not impinge on their rights to the property in case of future default. Moreover, the bank will insist on the protection of their past and current financial commitments to the project. Frequently, along with the loan modification agreement and the borrower's acknowledgement of its' past loan default, the bank will establish certain explicit future performance standards which, if not met, will render the loan in default, thereby allowing the bank to begin foreclosure proceedings. In addition, should a future default occur, the bank will wish to minimize the borrower's ability to combat the foreclosure action. Therefore, in the forum of the workout, the bank will insist on the release of all future lender liability claims.

A Bank will also place great priority on the preservation of its past and future financial commitments to the project, posturing that it does not wish to modify the loan and forgo its foreclosure rights to its' own detriment. When projects have junior liens, the bank will take great care to maintain its' lien priority, which often requires the agreement of junior liens with or without new money being supplied by the bank. Moreover, in order to protect its' lien's security from future devaluation, the bank may require additional collateralization or guarantees.[20][21][22][23][24] Usually this is also necessary for the bank in order to make the loan a performing loan.[25] In some cases, the bank may also negotiate for participation in the project's future cash flow and appreciation, establishing a participation agreement in the loan modification.[26]

Borrower Considerations:

Within the forum of a loan modification workout, a key concern of the borrower is the viability of the final agreement. Time extensions allow the effects of a workout solution to take hold. These extensions are manifested most often in the form of a foreclosure forbearance agreement, which states that the bank will abstain from foreclosing on the property for a stated period of time and which frequently is conditional upon the borrower meeting specified performance standards.

As a practical matter, the borrower must negotiate for an agreement which provides reasonable compensation for the time and equity committed in the workout. Even the lender recognizes that borrower liability is often insufficient inducement for an owner to continue with a problem property. In such instances negotiations concentrate on establishing equitable financial inducements, which allow for the owner to remain a financially viable entity, with some form of future potential profit. The borrower will also attempt to minimize any additional personal liability and collateralization. Similarly, the owner will negotiate for reducing current personal liability, especially when the market value has already decreased below the project's debt.[27] Since the bank wishes to keep the "fire under the owner", it will rarely agree to immediate reductions in personal liability[28], but may in some instances agree to staggered personal liability reductions, conditional on reaching other specified project performance levels.[29]

Another consideration of the borrower is the procurement of new funds, when the workout requires it. With the severe credit crunch in the real estate market, often this means acquiring these funds from the lender in the workout. Moreover, since any borrower who enters a workout will find it more difficult to obtain financing in the future, a borrower should acquire a "good borrower" letter from the lender. Although often conditional on the acceptable future performance of the borrower, the lender should agree to stand behind such a statement in the future. This letter should state that the problems which arose to necessitate the workout were due to unforeseeable economic or market changes. Furthermore, that the borrower possesses exemplary management capabilities. In this way the borrower will limit the damage done because of entering into a workout negotiation.[30]

WHITE KNIGHT ACQUISITION OF THE PROJECT:

The white knight can take many different forms, although the essence of the concept remains the same -- a "new person with new money". The white knight may purchase a portion of the property or all of it from the existing developer. The new money may be used to fund project improvements, meet unpaid costs or pay down existing debt, or some combination of the three. This person or entity also greatly enhances the viability of the workout for several reasons. Besides bringing potentially attractive management capabilities, the white knight brings money to a cash starved environment. Therefore, he commands negotiation power with the bank, that the owner does not. Workout committees are far more inclined to back a new person, rather than relying on the old owner who has already proved his inability to salvage the situation. As one workout expert suggested, banks will often choose a workout scenario financially less attractive but with the white knight involved over another with just the owner involved.[31]

The Borrower Controlled Avenue of Resolution

CHAPTER ELEVEN:

Chapter eleven is a voluntary bankruptcy filing in which the developer seeks to salvage a property or his total corporate financial holdings by implementing a court approved restructuring plan. Through a recent Supreme Court ruling, individuals can now personally file for chapter eleven. This may have far reaching affect on the way a developer handles workouts in the future -- time will prove its value. However, in the real estate context today, since most properties are held in either corporate or partnership form, chapter eleven filings are usually implemented in order to avoid a creditor's foreclosure action on the partnership's property.

"Upon bankruptcy petition, a stay is instantly put in place against all other petitions, with certain exceptions such a criminal or zoning proceedings."[32] This allows the borrower safety from legal actions, until the court has time to determine that it should be otherwise.

During the initial stages of chapter eleven hearings, the court will determine whether there were any preferential transfers, which for the purpose of equity to the creditors should be overturned. There are a number of guidelines within bankruptcy law which determine whether a transfer is preferential.[33] Usually transfers which have occurred within ninety days to unrelated parties will be reviewed, while for related parties (for instance, family members) transfers within one year prior to bankruptcy filing will be reviewed.[34]

Also during the initial stages of chapter eleven hearings, the creditors will petition the court for either a relief from stay or a bad faith filing ruling. A relief from stay allows the particular petitioning creditor to continue its legal proceedings outside the bankruptcy court, which usually means the continuation of a foreclosure action. The purpose of a bad faith filing ruling is to have the court rule that there is no possibility for the developer to resurrect his property, partnership or corporation, and therefore the bankruptcy filing should be changed to a chapter seven filing, which mandates the liquidation of holdings for the benefit of the creditors. These are major hurdles for the borrower, for which he must come prepared to defend against in the bankruptcy court.[35]

Another area of concern for creditors is how the court views their security. A judge may rule that a creditor is so secure in their lien that current interest will not be paid to that lien holder. Conversely, creditors which have no security will most probably not be due current interest on their lien either, since presently they have no hope of remuneration, and can only hope that they will in the future through restructuring. Because of these dynamics, when entering a chapter eleven proceeding, nearly all creditors try to convince the court of a property's value being just above or equal to their level of debt against the property. If this is determined to be the case, the court will likely award that creditor current interest on its debt, so that there in no potential for the security of that lien holder diminishing.[36]

The Restructuring Plan:

In the first one hundred and twenty days after filing for chapter eleven bankruptcy, the borrower has the sole right to file a restructuring plan which will be ruled upon by the court, thereafter any creditor may file an alternative restructuring plan.[37] The two key issues which the plan must satisfy are that the plan is equitable and viable. Courts usually view equity in the context of chapter seven. That is that whatever a creditor would most probably receive in a liquidation in today's market should be acceptable through a restructuring.[38] Viability is determined by the court and creditors, which will be more thoroughly discussed in the ensuing chapter. However, generally a plan is considered viable when the problems are considered temporary in nature or rectifiable, and through the plan creditors will be better off than through a chapter seven liquidation. Moreover, great emphasis will be placed on the believability and feasibility of the plan. Correctable problems include such circumstances as: "when the business is starved for capital, construction is unfinished, the business is broken and needs to be fixed, nobody's buying, the business is laboring under impossible burdens, uncoordinated and hostile actions among creditors are actually hurting the creditors themselves, onerous, unreasonable or hostile contracts must be terminated, or when control must be changed to prevent assets from being wasted."[39]

Within a borrower's plan the creditors are segregated into different classes of debt; each class should be comprised of creditors with similar claims. The actual classification of creditors is subject to the scrutiny of the court. If it is determined to be irregular -- because the borrower has classified creditors in a manner geared towards ratification of the plan, rather than objective similarities -- the plan may be ruled untenable, thereby resulting in a ruling against the borrower's plan. Therefore, it is in the borrower's best interest to make reasonable, tenable classifications.[40]

Obtaining ratification of a restructuring plan is complicated and problematic. Within the plan each class will receive a general treatment or payment schedule. The creditor classes will be characterized by the court as secured (unimpaired) or impaired.[41]

> "A class of claims is considered impaired by the plan unless it has the following status: the plan leaves unaltered the legal, equitable, and contractual rights of claims holders in the class; the plan cures all pre-bankruptcy arrearages, reinstates the maturity of the claims, and compensates the claims holders for damages incurred as a result of reasonable reliance on their

contractual provisions; or, the plan pays the allowed amount of such claims in cash on the plan's effective date."[42]

This differentiation is important since only impaired classes are allowed to ratify a plan. Unimpaired classes have priority in distributions and are considered secured, and thus are deemed to have accepted the plan. An impaired class accepts a plan when at least two thirds in amount and one half in number of its members approve the plan.[43]

"If all classes of impaired claims accept the plan, and if the debtor satisfies all of the other elements of Section 1129(a) of the Bankruptcy Code, the bankruptcy court will confirm the plan, and the plan becomes binding on all creditors. If, however, the plan does not receive a sufficient vote in all impaired classes, but at least one impaired class does accept the plan, the plan may be crammed down, provided that the court believes that the plan does not discriminate unfairly and is fair and equitable to the dissenting class or classes."[44]

Thus, a dissenting class of creditors may be forced to accept a plan, their objections "crammed down".

One complicating factor to this process is the rights of partially secured creditors under 1111(b)(2) of the bankruptcy code. Under this section of the code, a partially secured creditor can elect to have his entire claim characterized as fully secured, thus necessitating provision under the plan for additional deferred cash payments for this newly characterized amount. A partially secured creditor becomes a wild card in the ratification of a plan. The creditor, if it believes that by remaining impaired it can control the voting class of undersecured creditors -- and thus voting down the plan, may choose to refuse to make an 1111(b)(2) election, and forfeit the additional deferred cash payments.[45] This, needless to say can severely curtail the probability of ratification of a borrower's plan, especially when there are many partially secured creditors.

Nevertheless, chapter eleven offers the only alternative available -- outside of a lender liability suit -- for a borrower when faced with an implacable lender marching down the foreclosure route. Lenders avoid chapter eleven proceedings since, outside of being subject to the rulings of the court, they inevitably incur significant time, resource and legal costs, for which they may never receive recompense. While the borrower will also incur significant bankruptcy costs, he may end up with the upside of ownership of the property; the lender has no such upside. Therefore, lenders, despite what they might indicate otherwise, must carefully factor in the specter of chapter eleven when negotiating with a borrower. Thus, the threat of chapter eleven can be a significant negotiating tool for the borrower, especially when the lender recognizes its viability. The lender is forced then to consider what a restructuring plan would be through bankruptcy, and if prudent structure such a deal before incurring the additional costs of bankruptcy.

1. William Reilley, Former Workout Executive of Bank of New England, June 20, 1991.

2. Anonymous Interviewee, Developer, General Partner, June 4, 1991.

3. Kim Meader, Senior Vice President, Classified Loan Department, Bank of New England, June 26, 1991.

4. Real Estate Finance, Eighth Edition, Brueggeman, Fisher, and Stone, Richard D. Irwin, Inc., 1989.

5. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

6. The Soldiers and Sailors Civil Relief Act was enacted to protect active military personnel from foreclosure while away on duty and unable to represent his/her interests.

7. Defenses to foreclosure will be covered in the final chapter of this thesis.

8. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

9. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

10. Anonymous Interviewee, Esq, Real Estate Law Specialist, June 20, 1991.

11. Real Estate Finance, Eighth Edition, Brueggeman, Fisher, and Stone, Richard D. Irwin, Inc.

12. Real Estate Finance, Eighth Edition, Brueggeman, Fisher, and Stone, Richard D. Irwin, Inc., 1989.

13. Lender liability and releases there of are discussed in greater detail in the final chapter of this thesis.

14. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

15. Anonymous Interview, Esq., Real Estate Law Specialist, June 20, 1991.

16. The first mortgage holder recognizes the potential of foreclosure or bankruptcy initiated by junior mortgage holders, and therefore refuses to diminish their claims under such actions.

17. " Workouts: A Borrower's Guide to Deferrals and Cash Flow Payments", Stevens A. Carey, The Real Estate Finance Journal, Summer 1991.

18. Anonymous Interviewee, Workout Specialist, General Partner, June 17, 1991.

19. "Workouts: A Borrower's Guide to Deferrals and Cash Flow Payments", Stevens A. Carey, The Real Estate Journal, Summer 1991.

20. William Reilley, Former Workout Executive of Bank of New England, June 20, 1991.

21. Robert Kelliher, Vice President, Classified Loan Department, State Street Bank, June 26, 1991.

22. Kim Meader, Senior Vice President, Classified Loan Department, Bank of New England, June 26, 1991.

23. "A Borrower's Guide to Real Estate Loan Workouts", Lesser and Klug, Real Estate Finance, Vol. 7 No. 2, Summer 1990.

24. "Strategies and Alternatives Available to Troubled Real Estate Owners", Carlsen and Kamer, The Real Estate Finance Journal, Spring 1990.

25. Claire M. Desjardins, Asst. Vice President, Federal Reserve Bank of Boston, July 9, 1991.

26. " A Borrower's Guide to Real Estate Loan Workouts", Lesser and Klug, Real Estate Finance, Vol. 7 No. 2, Summer 1990.

27. Anonymous Interviewee, Workout Specialist, General Partner, June 16, 1991.

28. Kim Meader, Senior Vice President, Classified Loan Department, Bank of New England, June 26, 1991.

29. Anonymous Interviewee, Workout Specialist, General Partner, June 16, 1991.

30. "A Borrower's Guide to Real Estate Loan Workouts", Lesser and Klug, Real Estate Finance, Vol.7 No. 2, Summer 1990.

31. Anonymous Interviewee, Workout Specialist, General Partner, June 19, 1991.

32. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

33. "When Bankruptcy Is the Best Survival Strategy", David A. Smith, Real Estate Review, Vol. 19 No. 4, Winter 1990.

This article reviews the qualifiers of preferential transfers.

34. Anonymous Interviewee, Workout Specialist, General Partner, June 19, 1991.

35. Anonymous Interviewee, Esq., Real Estate Law Specialist, June 20, 1991.

36. Bill Reilley, Former Workout Officer for Bank of New England, June 20, 1991.

37. "When Bankruptcy Is the Best Survival Strategy", David A. Smith, Real Estate Review, Vol. 19 No. 4, Winter 1990.

38. Anonymous Interviewee, Workout Specialist, General Partner, June 19, 1991.

39. "When Bankruptcy Is the Best Survival Strategy", David A. Smith, Real Estate Review, Vol. 19 No. 4, Winter 1990.

40. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

41. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

42. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

43. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

44. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

45. "The Threat of Cramdown: How Real Is It?", Michael L. Molinaro, Real Estate Review, Vol. 19 No. 3, Fall 1989.

CHAPTER FIVE

Global Workout Strategies

> "Workout is an art and not a science. There are no absolute rules. Certainly knowledge and experience are necessary...but not the only ingredients. That's why technicians, lawyers etc., don't make good workout persons in general. Success lies in the ability of the workout specialist to perceive each property's problems, the issues surrounding the problem, and how the lender perceives the situation. How does the creditor that you happen to be talking to perceive the developer? If they perceive a bad faith creditor, you'd better change their attitude quickly...If a lender is wrong about where they think they stand, you must change that perception...Anybody who does a workout by the book is not going to be a good workout person." [1]

Experience and intuition allow a workout specialist to understand where a bank differs in opinion on a property with its borrower(s), and work towards aligning those opinions with the borrower's. Moreover, it allows for an assessment of a bank's potential negotiating flexibility with a problem property, thereby enabling the workout specialist to obtain the most favorable workout alternative available.[2]

This experience is necessary due to two main areas of uncertainty. First -- each bank handles a workout differently. It depends on their workout capabilities, regulatory scrutiny, perception of the market's future and internal agenda in response to these factors. For instance, one of the largest banks in Boston recognized the extent of the problematic market and their loan portfolio very early on, resulting in the bank taking a very aggressive posture in their workout negotiations. Outside observers noted that the bank opted for taking back properties quickly, unless there was a clear, highly probable workout solution. It can be surmised that this bank concluded that it would be able to get past this troubled time more quickly than other banks by adopting this agenda.

Other banks, however, have taken a slower approach to their real estate loan problems because of a smaller magnitude of loans in default, or a less pessimistic perception of the market. In addition, there are often other mitigating factors. For instance, many banks do not have a separate workout department to handle problem loans, thus relying on loan officers to handle these situations. These loan officers are often ill prepared for the additional responsibility. This is certainly true of many thrift institutions and even some smaller commercial banks. Even banks with workout departments may have varying levels of expertise.

Similarly, banks have varying appetites for taking back properties to be held in OREO, and therefore some banks may be willing to negotiate agreements that other banks would never consider. There is no way for banks in general to follow one correct internal agenda for dealing with real estate loan problems. For the real estate owner, however, it is important to understand that banks treat workout negotiations in very different ways. A borrower must perceive the internal agenda of a bank in a workout environment and the workout abilities of the officer assigned to his particular loan, subsequently acting in a prudent manner according to these perceptions.[3]

Just as there are varying internal agendas within banks regarding workout negotiations, so too are there varying personalities and capabilities among workout officers. Some may adopt a hardline posture to negotiations, with the attitude that unless the borrower acts in response to their wishes the borrower will suffer the legal consequences, while others may be more considerate of the situational conditions which brought on the problem. However, despite varying negotiation tactics, the main consideration of the borrower should be to recognize that workout officers, like everyone else, are subject to their personalities and capabilities. If a workout officer feels that you are not working with him, are dealing in bad faith or just doesn't like the borrower's attitude, his negotiations will be conducted largely in response to these attitudes. This becomes especially problematic when the lending officer, who may have in fact originated the loan, conducts the workout negotiations. In this case, it may be hard for him not to feel let down or betrayed by the borrower, and therefore not conduct negotiations in a objective manner. Nevertheless, borrowers need to develop the intuitive capabilities to understand the varying ways a bank and its' workout officer deal with a workout, in order to successfully survive in a workout environment.[4] As a first step in this process, a borrower must understand the regulatory scrutiny which banks experience, as well as their objectives and considerations in a workout environment.

Workout Negotiation Preparation:

Nearly every real estate owner and developer who begins to have problems with their properties goes through a trying period of conflicting emotions. This is especially true of borrowers who have not experienced a recessionary market before. They suffer through periods of denial, anger and depression before becoming resolved to their situation and beginning to make positive progress towards the resolution of their problems. The borrower needs to recognize that this is a natural reaction, and by so doing hasten its progress, and concentrate on the work at hand.[5]

When a borrower is confronted with the reality that many of his properties are suffering problems which necessitate a workout discussion with the bank(s), he must first go through a process of preparing property specific and personal financial information which will be needed in the workout negotiations. At the same time he should engage legal counsel to become familiar with his rights under the loan documents and applicable business statutes. Finally, the borrower should review his company's operations, being mindful that the lender will be assessing his management capabilities during the negotiations.

When preparing property and personal financials, the borrower should take a conservative approach. It does not pay either the lender or borrower to negotiate deals based upon overly aggressive financial information which could eventually lead to a second default by the developer. If this happens, the borrower exposes himself to a potential liability suit for misrepresentation, and at the very least tarnishes his reputation as a competent manager.

The borrower should produce property specific information which includes a property description, a status indication (in example workout, foreclosure, default or current) so that the bank can assess the borrower's overall portfolio condition, a conservative property income statement, and finally a list of the property's liabilities (secured debt, mechanics liens, trade debt, etc.). Most importantly, the developer should not indicate his estimate of value, this can be done in negotiations if necessary.[6]

Personal financials should not be produced in the standard format either. As one workout specialist said:

> I do not encourage a developer to give a standard financial statement. If it is ever perceived later as a request for forbearance, forgiveness or whatever, and the deal doesn't work out as perceived, I don't want the bank to have recourse against the developer, arguing that the only reason we did this deal was because of you representations on your financial statements. Value is the problem here. It absolutely serves the developer no purpose to give the bank a financial statement that says this is what my properties are worth. The bank has enough technical experts in the bank or available to estimate the valuation of the project...There are other ways to do it. List the project describing it as best you can, liabilities, status, etc., and then state the developer's estimate of what is his net equity in each property...He's not saying how he arrived at this number; he could be talking about the future value,

which is conditional on his ability to cut certain deals. This doesn't mean you list zero since you can't negotiate in bad faith.[7]

"Banks always ask for personal and property financial statements, because absent information neither they or anybody else can make a decision that they feel will not be criticized later."[8] Therefore, it benefits the developer to have this information prepared as indicated, since it expedites the progress of negotiations.

In addition to the preparation of descriptive financial information, the borrower should also review his company for operational inefficiencies. More than ever, the borrower must be the head of a streamlined, highly efficient management firm. "Regardless of anything the borrower can bring to the table in a loan restructuring, the lender cannot justify a workout strategy that includes the borrower if the borrower cannot effectively manage the property...A borrower should approach the lender armed with information and material that will convince the lender of its managerial capabilities."[9]

The production of this financial and management information prepares the borrower for the inevitable request from the lender for it. Timely, cooperative response to these requests, not only provides the lender extra time to work towards a successful restructuring, but it also creates a favorable impression of the competency and efficiency of the borrower, which is necessary for the lender's comfort in pursuing a continued relationship. This impression can be especially augmented when it is the borrower who broaches the need for workout negotiations -- even before loan default, and comes to the first meetings prepared to discuss a specific workout plan he has originated. Such a proactive approach can help the borrower control the workout agenda, and should be adopted where possible.[10]

Portfolio Review and Analysis:

Having reviewed each of his properties, a developer must next make some hard decisions as to which properties to keep and which properties to eliminate from the portfolio through a deed in lieu or foreclosure transferral. While there are no rules for such analysis, there are clearly some considerations to keep in mind.

First, the developer must make realistic assumptions about the value of his properties. Too often a real estate owner feels that a property must be worth at least the mortgage amount. This may not be the case, especially with properties which will produce no income in the near future, such as raw land or projects stuck in approval. "We are in times where valuation is a very difficult thing...what a developer really has to do is produce a NOI that's real...and then translate that with a ten or eleven capitalization rate (a conservative cap rate) to come up with a value, especially in the absence of any comparables."[11]

Having performed these valuations, the developer must then look at the property from a liability standpoint, comparing the value and level of debt to ascertain potential equity. It is important to note that just because there appears to be no equity in a particular project, or even a deficiency, this doesn't necessarily mean that a developer should decide to eliminate the parcel through a deed in lieu or foreclosure transferral. In some instances, through a loan restructuring or a discounted payoff, a borrower may be able to create equity. Moreover, in marginal equity cases there still may be financial inducement to retain ownership due to a flow of management fees.

The foregoing analysis gives the owner an initial survey of properties that may be worth saving in a workout environment. However, while doing this analysis, the developer must always consider three key issues. First, what are the workout postures of banks that the borrower will be dealing with? A borrower must weigh the viability of particular workout scenarios in light of the banks he is working with. Chapters two and three give some insight into this assessment, but proper negotiation strategy cannot be taught through traditional methods.

Second, the borrower must always remember that cash flow is king. Unless the resulting workout portfolio provides cash flow to the borrower he may not be able to ultimately weather the storm. There has to be some incentive to withstand the aggravations of a workout. If this can't be achieved the best alternative may be chapter eleven (see chapter eleven discussion in chapter four).

Thirdly, how does the outcome in each workout scenario affect the borrower from a tax standpoint. Borrowers often overlook the tax ramifications of their workout agreements, when conducting workout negotiations. These tax ramifications should always be an integral part of a developer's strategy when going through a workout. In such situations, borrowers should always retain a competent tax consultant. Some tax issues worthy of consideration are highlighted below.

Tax Considerations:

When modifying a loan in workout, a borrower must be cognizant of the possibility of generating debt forgiveness income. Governed by the original discount rules, the key issue is whether by modifying the loan the old debt is deemed exchanged for a new debt instrument. This is determined by scheduling out the principal and interest payments and discounting them back at the applicable federal discount rate to obtain a present value of the old and new debt. The difference between the two may be deemed debt forgiveness income. The borrower needs to plan around this potential tax liability when negotiating a loan modification.[12]

In the instance where a "white knight" becomes the solution, the adjusted partnership may reduce the debt sharing of the old partners, thereby resulting in a deemed distribution, with potentially adverse tax consequences. These tax consequences occur when the constructive distribution exceeds the existing partner's tax basis, or if a deemed sale is triggered. If the debt is recourse and the new partner does not bear any economic risk (i.e. enters as a limited partner), then no cost basis change will occur for the old partners. However, if the "white knight" guarantees prior non-recourse debt, or takes on a portion of the existing economic risk, the old partners may be subject to adverse tax consequences.[13]

Any Foreclosure, or "deed in lieu", transaction subject solely to non-recourse debt is deemed a sale or exchange for the amount of the debt. With the amount realized on the exchange being the full amount of debt, taxable gain results from the difference between the amount of debt and the basis in the property.[14]

With recourse debt, when the fair market value of the property conveyed is greater or equal to the debt, then the amount realized through conveyance is equal to the amount of debt.[15] However, if the fair market value is less than the recourse debt, then the transaction must be bifurcated into taxable income and debt forgiveness income. In a bifurcated transaction the difference between the fair market value and the cost basis is deemed taxable income. Any debt discharged which exceeds the fair market value is deemed debt forgiveness income. In example, suppose the following foreclosure scenario: Cost Basis=$100,000, Recourse Debt=$200,000, and Fair Market Value=120,000. In this case, the taxable gain would be $20,000 and the debt forgiveness income would be $80,000. Section sixty one of the tax code describes debt forgiveness as a type of income since it is interpreted as a form of enrichment; money which would have offset the forgiven liability can now be used for another purpose.[16]

Section one hundred and eight of the tax code provides an important exception to the taxation of debt forgiveness income. This section of the code provides that forgiveness income is not taxable in three cases: "1). a bankruptcy discharge under Title 11; 2). a discharge while the taxpayer is insolvent; 3). a discharge from qualified farm indebtedness". The most important qualifier for real estate owners is "a discharge while the taxpayer is insolvent", with insolvency defined as the excess of liabilities over the fair market value of assets. This exclusion is applicable until the point that the taxpayer becomes solvent. However, for this benefit the taxpayer must pay a toll charge defined under section one hundred and eight. For the exclusion of otherwise taxable income, a reduction of certain tax attributes must be made: 1). net operating losses;2). general business credit carryover; 3). capital loss carryover; basis reduction; foreign tax credit carryovers. The reduction is dollar for dollar, except for general business credit and foreign tax credit carryovers which are one third that amount.[17] Since the debtor can choose the means of reduction, reducing the basis of a property which may be held until better financial times or death offers a significant tax planning alternative.[18]

Portfolio Workout Issues:

Before addressing the actual preservation or elimination negotiations necessary in a portfolio workout, certain issues must be addressed. The first two affect the relative negotiating strength of the borrower when going through the portfolio workout process. The third regards the borrower's need to maintain a honorable reputation. Finally, a strategy for dealing with unsecured debt will be considered.

The form of property ownership, whether all the properties are held by one entity or each property is held by a separate partnership, will dictate the size of the hammer held by the lender. Specifically, when the lender goes through workout negotiations, if all the properties are held by one entity, the lender will feel that it has deficiency recourse through the other properties, and therefore will not necessarily agree to deficiency forbearance agreements. Since the borrower cannot throw just one partnership in Chapter 11 (which is not the case when properties are held in separate partnerships), and is working against a global bankruptcy, the bank knows that it may have a significant negotiation threat. The bank will be looking for a deficiency payoff by the borrower or even other banks involved in the portfolio workout. This is one of the reasons that borrowers often try to have a global workout, with all the creditors involved at once. The argument for such a global workout is that it eliminates the sway one creditor may have on the workout, since each bank's claims will be offset by the other banks', forcing them to work together for a common solution to the borrower's troubled portfolio. The argument against this method, however, is that each bank has a separate agenda which may make it impossible for all to agree on one solution. If just one bank refuses to go along with an agreement, then the borrower may be forced into an involuntary bankruptcy. Therefore, whenever possible, a borrower should try to keep negotiations separate. While this is not impossible, it certainly is not an easy accomplishment.[19]

Ironically, when a owner only has a few workout situations and a goodly amount of equity in the remaining properties, the workout bank may have greater negotiation powers, because it will always have deficiency recourse in the equity of other properties in the portfolio. When the borrower does not have much equity in other properties, the lender will be negotiating in fear of the borrower's ultimate bankruptcy, especially when the bank is negotiating for the transferal of title. The bank will want to structure a deal which is consummated at least ninety days before bankruptcy, so that the transfer is not considered a preferential transfer. In the case of a loan restructuring, the bank will know there is no deficiency recourse but that it is already secured by the property to the extent it ever will be, and in fact will be trying to keep the developer out of personal bankruptcy.[20]

There is one way, however, that a borrower can be assured that he will suffer either a partnership or personal bankruptcy. If a borrower is perceived (even if he is not) to be dealing in bad faith, commingling funds, fraudulently transferring money, doing property transfers for less than value or even burying money in the ground, he can be assured that a bank will move quickly to protect their interests. In other words, in absence of other recourse, they will throw the partnership or the developer into involuntary bankruptcy. The point is that a borrower must take every precaution possible to assure the bank of his legitimate, legal commitment to the rectification of his problems. Too many developers have been thrown into bankruptcy, and face the specter of jail because of the illicit movement of funds for this not to be completely true.[21]

The final issue to be addressed is the handling of unsecured loans. Frequently, real estate owners have large amounts of unsecured credit, which were used for personal reasons, operational shortfalls or property maintenance. When the unsecured creditors recognize that the borrower is having troubles by a default or otherwise, they will immediately accelerate the loan and seek payment. Since what little cash reserves the borrower might possess are needed for other critical issues, repayment of credit lines most likely will not occur. Therefore, the only recourse for the unsecured creditors is to seek a deficiency judgement, which allows the unsecured creditor to attach a lien on one of the properties owned by the developer. In many cases, if a borrower allowed every unsecured creditor to attach to the few properties which still had some equity there would be no reason for the borrower to avoid bankruptcy. Besides being the financial upside for the borrower, the remaining equity in the portfolio must be preserved often times so that secured creditors can obtain additional collateral, which is necessary for a loan restructuring -- so that the bank can show their loans as performing loans. For these reasons, it is critical that a developer avoid allowing the unsecured creditors to attach their judgement liens to his properties. Needless to say, this can be a trying exercise.[22]

The borrower should attempt to persuade the unsecured creditors who are pursuing judgement liens that there is limited equity in the portfolio and that in order to complete a successful portfolio workout, the developer will have to preserve that equity. Since it is not equitable to secure only a few unsecured creditors, the borrower should not secure any of them. If any unsecured creditor attaches to a property, the borrower will have to let the other unsecured creditors know, and in fact may throw the property or himself into voluntary bankruptcy, where the particular creditor may be deemed a preferential transfer or gain less than nothing -- because of its' resulting legal costs.[23]

In most cases, the amount a property will sell for in a involuntary liquidation will never provide recompense for unsecured creditors. Therefore, most reasonable unsecured creditors will be willing to work with a borrower through his problems, hoping that after the borrower becomes financially sound again the unsecured creditor will be paid off, or at least partially so. In the interim, the borrower may be able to negotiate with the unsecured creditor a deal which includes a long forbearance agreement and establishes the amount owed (which often times may be less than the amount loaned), with early payoff reductions to that amount. An alternative to such separate agreements is a pooling agreement, in which all the unsecured creditors agree to one deal. This agreement will allot percentages to each creditor. When the borrower begins to sell his properties for a profit, a portion of the funds will be given to the pool, and distributed according to the creditor's allotted percentage.[24]

In either case, if it comes to pass that the developer has excess dollars after paying off the secured debt, the unsecured creditors will most likely agree to a partial payment in exchange for the extinguishing of the debt. They are forced to realize that the developer can not work forever to repay past debts[25]; "most people recognize that slavery is unconstitutional."[26] If that were not the case, the borrower would still declare bankruptcy, and so creditors will agree to a discounted payoff.

Workout Negotiations:

To a great extent the majority of the issues which are involved in workout negotiations have already been discussed in this thesis. Chapter two explains the influence that the regulatory agencies have on banks in a real estate workout environment, through their review, rating and corrective actions. Chapter three reviewed the progression of a troubled loan through a typical bank, until the point it is turned over to a workout department. It then considered the financial and non-financial objectives, as well as the defining constraints of a bank in a workout negotiation. The purpose of those chapters was to provide a knowledge base to assist a borrower entering a workout negotiation.

Chapter four explained the avenues that can be followed in a workout situation, as well as the negotiation goals of the lender and borrower in a loan restructuring. Chapter five has thus far reviewed the specific portfolio and tax issues which a borrower must consider before entering workout negotiations. The final topic this thesis will consider is the negotiation tacts that a developer can take when negotiating the restructuring of a loan or the transferral of title.

Loan Restructuring:

In the initial stages of the loan restructuring negotiations the lender will be assessing the quality of real estate management and expertise the borrower brings to the situation. As we have discussed, the borrower exhibits this expertise through the timely production of information on the property and its' guarantors. Moreover, he should be prepared to address the default with a cogent, realistic loan restructuring plan. As we have considered, these workout negotiations are subject to the vagaries of the bank and its' workout officer, and therefore the borrower's workout representative must perceive the unspoken issues involved in the negotiations, in order to respond accordingly. During all of these negotiations, the borrower must attempt to bring the workout officer's understanding of the issues in concert with the borrower's, thereby creating a workout deal the borrower can live with (see chapter four for the negotiations objectives of the borrower in a loan restructuring).[27]

To the extent the workout representative cannot bring about this meeting of the minds, he must consider his options. This may mean considering the viability of a lender liability suit, if indeed there is a basis for one. It will certainly mean considering a chapter 11 filing, if there is no other alternative. Depending on the strength of either alternative, the bank will be forced to factor in the time, legal and resource costs of getting involved in a lender liability suit or chapter 11, while conducting the restructuring negotiations. By doing so, the bank is forced to consider the alternative of not coming to an agreement on a loan restructuring, the result being that it may agree to negotiation points to which it might otherwise have not.[28]

While there may be no easy way to discuss a lender liability suit with the lender, chapter 11 discussions do not have to be of a combative nature. Indeed it serves no purpose for the borrower to be combative, the borrower must always strive for a cooperative negotiation towards a common goal -- the resolution of a problem loan. When discussing chapter 11 it should never be a threat, but rather the natural alternative for the borrower, since he is so committed to the preservation of the property. In many ways, it only witnesses the borrower's commitment. These are the last trump cards for the borrower, before he is actually forced into a foreclosure or voluntarily filing for restructuring in bankruptcy.[29]

One negotiation tactic which can be very effective is to approach the lender with the following proposal: " since the partnership will be going into chapter eleven if we don't come to an acceptable agreement, we will both suffer additional costs, with the ultimate outcome being a court approved deal. Therefore, why don't we project where we would be after a waiver of stay is defeated, and go forward and see what the plan might say. Let's do a non-eleven eleven".[30] If the bank recognizes the viability and possibility of the borrower's success in bankruptcy court, it may choose to forgo the additional time, legal and resource costs of chapter eleven, and more aggressively work towards a consensual deal.[31]

Another consideration is how secondary debt may in fact help the workout negotiations. Frequently, when a secondary creditor recognizes the intentions of the first mortgage holder to foreclose (thereby wiping out the remaining lien holders), it may choose to salvage the situation. If the second mortgage holder perceives that there is potential equity to collateralize its claims either now or in the future, it may choose to protect its claims through a number of mechanisms. It might consider a partial paydown of the first mortgage, in order to make it a performing loan, subsequently increasing its secondary lien. Another possibility is that the second mortgage will wrap the first, and in some way guarantee the continued servicing of the first mortgage. In either case, the second mortgage holder will want assurance that the first mortgage will not afterwards reinstate its foreclosure action. This most commonly will involve some sort of forbearance agreement.[32]

During the workout negotiation, the borrower may have a tendency to be focussing on just ending the default problems. However, the borrower must establish certain goals before entering a workout negotiation which go beyond resolution of default.

First, a borrower must strike a deal which will hold up to the test of time. A new deal should be able to weather continued real estate market declines and other property setbacks. Banks are focussing on getting as much debt service as possible through the restructuring, but the borrower must focus their attention on the practicality of continued existence of the deal. It serves neither the lender or the borrower to structure a deal which will go into default again within a few months.[33]

Second, a borrower must structure a deal which provides adequate management fees to not only pay employees, but also the developer. The borrower must recognize and provide for the necessity for adequate personal income during the period of workout, until such time as his business will become profitable again.[34]

Third, the developer must insist that the lender agree to significant forbearance agreements, providing a reasonable time frame of safety for the borrower to resolve his specific property and portfolio problems. A workout agreement is of no value to the borrower, if the lender will be able to pursue foreclosure four months later. The developer should be confident that he will not have to divert resources to the resolution of an agreement shortly after coming to a first workout agreement. The developer must realize that his problems may not come to an end for quite some time, and therefore must provide for this eventuality.[35]

Finally, the borrower must always negotiate for minimal collateralization on other properties. This is one of the few things of value that a borrower may offer when negotiating workout deals for his portfolio. Since it is a limited quantity, the borrower must spread it as thinly as possible.[36]

Transferring Title:

When negotiating for the elimination of a parcel, the borrower will be forced more than ever to convince the lender of his poor financial condition. Once the borrower identifies the properties he wishes to eliminate,

> "the first step is to go to the lenders and convince them of the facts so to speak...You may spend a lot of time convincing them of what your analysis is: that there is no market out there right now for this property; that there are comparables; that no one knows what the upside is going to be and when, etc.".[37]

Nevertheless, the borrower should approach the property negotiations as if he intends to structure a workout deal, going so far as to suggest his intentions of following the chapter eleven route if a deal can not be made. The lender may be inclined to strike a workout solution which makes the property a more valuable asset to the borrower. Otherwise, the bank may indicate its intention to gain title, and that it would prefer an amicable transferral. This will put the borrower in a position to demand a minimal deficiency agreement, in lieu of fighting it out in chapter eleven.[38]

Thus, an approach that could be taken is to show the lender that the developer in this market may have a negative net worth, and in fact may be on the precipice of a global bankruptcy. So before this happens, why doesn't the bank take the property back and waive the deficiency quickly, so that they can avoid a preference ruling if the borrower does in fact go into bankruptcy.

> "Generally speaking most banks, as long as they are sure the borrower has done nothing which is illegal and detrimental their position..., will look hard and fast at just taking the property back, hoping a preference period goes by, and disposing of it and walking away."[39]

In any case, besides the transferral of title, the developer will be concentrating on minimizing the agreed upon deficiency and maximizing the forbearance period. Again the borrower must protect itself from later actions, which may debilitate the borrower or force the borrower to file for chapter eleven. In addition, the borrower should try to contractually agree to discounted deficiency payoffs, to which, considering the potential for borrower bankruptcy, the lender should happily consent.[40]

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CHAPTER SIX

Conclusion

Throughout this thesis the author has tried to provide a base level of information on the issues surrounding workout negotiations, with an eye towards negotiations which ultimately lead to the survival of the borrower through a real estate recession. A borrower must understand the regulatory forces (chapter two) which affect the way a bank approaches a workout. Moreover, the borrower must understand the workout mechanisms, objectives and constraints of the bank entering a workout situation (chapter three). In this way, the borrower may develop the intuition necessary to successfully negotiate with the lender. Part and parcel to these successful negotiations, the borrower must understand the complexities of potential avenues of resolution for workouts. (chapter four). Finally, the developer must develop a proactive portfolio workout strategy, which enables the to borrower to negotiate effective agreements leading to the ultimate survival of the real estate owner and his company. This is a complex, multi-disciplined area, which first and foremost necessitates a real estate owner to surround himself with competent professionals. However, the borrower must groom and guide these talents towards a successful end.

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