

# Workouts From The Borrower's Viewpoint (With Form)

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Make the best of a bad situation.

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**FROM A BORROWER'S PERSPECTIVE**, defaulting on a loan is not an optimal situation. The borrower faces potential foreclosure and possible personal liability for guarantors. The specter of bankruptcy may loom. So how do borrowers make the best of a bad situation?

For many borrowers, if the lender is willing, workouts offer a potential middle ground between bankruptcy and foreclosure. A workout is a negotiated solution to a distressed loan, where the lender accepts something less or at least different than the deal for which it bargained in the original loan documents. W. Wade Berryhill, Joel B. Eisen, & Michael J. Herbert, *Structuring Commercial Real Estate Workouts: Alternatives to Bankruptcy and Foreclosure*, §1.02 (2d ed. 2010). A workout requires a willing and able borrower, a willing lender or lenders, and a project whose fortunes can be realistically can be reversed.

**BORROWER'S GOALS** • A borrower's goals will vary from workout to workout. Limiting the liability of principals and any guarantors often is a primary goal. Another obvious borrower goal is to retain ownership of the real property collateral and related equity so that it can reap future gains

from the property. See Douglas Van Gessel and Katharine E. Allen, *Real Estate-Secured Loan Workouts: The Borrower's View*, Pratt's Journal of Bankruptcy Law 262 (April 2009). Another objective may be to avoid foreclosure or bankruptcy, both to avoid the actual event and for the sake of the borrower's reputation. See generally, Berryhill, supra, at §3.03. Other goals may include:

- Avoiding damage to other assets through cross-default or financial covenants in other loans;
- Extending loan maturity dates;
- Keeping current management in place; and
- Reducing loan payment obligations.

See Van Gessel & Allen, supra, at 263.

**TYPES OF WORKOUTS** • Workouts can take many forms, which, depending on the nature of a distressed portfolio, can be combined. Forms include:

- A loan modification;
- Lender's assumption of control of the property;
- The borrower's conveyance of the property to the lender by a deed in lieu of foreclosure;
- Transfer of the property to a third party by sale;
- A third-party's completion of a construction project; and
- The appointment of a receiver for the property.

See Curtis Berger and Quinton Johnston, *Land Transfer and Finance* 318 (4th ed. 1993) and David Black, *Loan Workout Strategies*, 4 Prob. & Prop. 39 (March/April 1990), cited in Berryhill, supra, §1.02 at 1-4, fn 3.

**ESTABLISHING AND MAINTAINING CRED--I-BILITY** • To convince the lender to allow the borrower to continue to own and operate the property, the borrower needs to establish and maintain credibility with the lender. Here are several "keys to retaining the keys."

### **Address Problems Proactively**

Once a borrower senses that it may be in trouble on a loan or loans, the borrower should address the problem proactively. The borrower should convene its team – its accountant, its attorney, and the key principals – to discuss matters and contemplate options. Rather than waiting for events to control the borrower, the borrower should prepare for and make strategic decisions about the situation.

### **Communications Strategy**

A borrower's communications strategy is a central piece of its workout strategy. In most instances, particularly if the borrower wants to continue to own and operate the property, the borrower is best served by

prompt communication of news – even (especially) bad news – to the lender. For example, a borrower should not delay in informing its lender that a major tenant has elected to terminate its lease or has defaulted on the lease. No one likes to deliver (or receive) bad news but, in most cases, it is better to disclose than to hide or delay.

Prompt communication of bad news establishes credibility with the lender. The borrower may need some time to assess the situation and develop a credible plan. The borrower should let the lender know both about the immediate news and that it is preparing a plan. In some instances, the borrower may determine that it should wait before disclosing bad news to the lender. Such a situation may exist, for example, if the borrower has the sense that the lender will be adamantly opposed to a workout and the loan documents give the lender the right to call a default if, in lender's view, the value of the collateral is impaired. Regardless, the borrower should decide when and how best to communicate bad news to the lender.

## **Cash Strategy**

In a workout cash is king. How a borrower handles cash can bolster or destroy a borrower's credibility with the lender(s). If the borrower's chief goal is to avoid foreclosure, particularly if the loan documents give the lender discretion in declaring a default, a time of default in the debt service is not the time for principals to pull cash from the project for unscheduled payments to principals. If there are loans from principals or affiliates to the defaulting borrower, default under the prime loan on the property is not the time to call those loans.

A defaulting borrower needs to look closely at the cash flow from a property and the property's cash needs. A critical issue is the extent to which cash flows from the property cover the debt service on the property. The borrower also should examine the property's needs. While the borrower may want to curtail expenditures to conserve cash (perhaps for a potential principal pay-down as part of a loan modification), neither the borrower nor the lender wants property maintenance neglected. Practical Counsel ([practicalcounsel.wordpress.com](http://practicalcounsel.wordpress.com)), *Workouts 101, Part 2: Borrowers' Leverage*, June 20, 2009. The borrower should assess other cash needs for a turnaround – consultants, accountants and lawyers. John M. Koneck, *Preparing for a Real Estate Workout*, 24 Minnesota Real Estate Journal, No. 9 (Sept. 2008). Lenders, on the other hand, will want as much cash as possible to go to them. The cash battle is often the "biggest issue in a workout." *Id.*

## **Assessing The Facts**

To evaluate workout possibilities and prepare itself for workout negotiations with the lender(s), borrower needs to assess in a comprehensive fashion the problem project(s), loan documents and other agreements, the market, and the status of entities, principals and owners,