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Borrower, Have You Started Preparing for Your Meeting With Your Lender to Discuss a Loan Extension or Restructuring?

PART II - HOW THE BORROWER NEEDS TO APPROACH THIS MEETING WITH ITS PRESENTATION AND PLAN.

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In Part I of this three-part blog on meeting with your lender, I discussed the new June 2023 Policy Statement (the "2023 Fed Policy Statement") issued by the Federal Banking Authorities (the “Feds”), the upcoming real estate crises due to $4-5 Trillion of office mortgage loans maturing in 2024 and 2025, an how the Feds foresee and want to modify current banking guidelines to assist both banks and borrowers in extending and restructuring their troubled commercial real estate (“CRE”) loans to get past the next few years.

In Part I, I also discussed how your lender will approach the meeting, what information it will need from the borrower and how the borrower needs to maintain the lender's confidence in the borrower by presenting a plan that "...*should improve the lender's prospects for repayment of principal and interest*...." (The immediately preceding quoted language and all quoted language in italics below are quoted from the 2023 Fed Policy Statement.)

So what is encompassed in the borrower presenting an extension or restructuring plan that will be acceptable to the lender?

First, the borrower has to make sure that the plan is not so one-sided in favor of the borrower that that lender will face a reclassification of (a) the loan by federal bank examiners (the "examiners") and (b) the payments received by the lender from the borrower to nonaccrual status.

Generally, if a loan extension or restructuring shows the borrower's ability to continue making loan payments based on reasonable terms, despite the decline in cash flow or market value of the collateral, a bank may classify such extension or restructuring as "***pass and is monitoring the credit***" or in laymen terms, it passes muster of review. If the examiners agree with the classification of an extension or restructuring as "pass and is monitoring the credit", the lender will not be adversely affected on its books by the transaction.

Similarly, the lender will not receive an adverse classification if the extension or restructuring is classified by the bank and examiners as "***special mention***." This means the negotiated extension or restructuring meets the above requirements for a "pass and is monitoring the credit" but there are weaknesses in the collateral that, if left uncorrected, may result in a deterioration of repayment prospects. Examples of such future weaknesses can include major leases expiring in the future, rents forecasted to trend downwards or the fair market value of the property being on a downward trend. With this classification agreed to by the bank examiners, the bank will not be adversely impacted, but it must maintain a process to monitor the loan.

If the lender and/or the bank examiners review an extension or restructuring and believe that, as a result of the transaction, the loan is inadequately protected by the current sound worth and paying capacity of the borrower or the property such that it jeopardizes repayment of the loan, the loan should then be classified as "***substandard***". With such a classification, the bank is acknowledging that there is a distinct possibility that the bank will sustain some loss if such weaknesses are not corrected. This classification is considered by banks and the Feds as an adversely classified loan.

If the bank and/or bank examiners believe the above type of weaknesses make collection or repayment of the extended loan in full highly questionable and improbable, on the basis of currently known facts, conditions and values, then the transaction will be classified as "***doubtful***". Again, this classification is considered by banks and the Feds as an adversely classified loan.

Finally, if the bank and/or examiners believe the extended or restructured loan are uncollectible and of such little value that their continuance as a bankable asset is not warranted, such extended or restructured loan will be classified as a "***loss***".

If the extended or restructured loan is classified as substandard, doubtful or loss, the bank is required to take various actions which will cause the bank to suffer differing degrees of pain and losses. Hence the goal of the borrower in presenting a plan should be to structure the plan so that the bank will not have to adversely classify the loan. There is no sense in the borrower proposing a plan knowing that the bank will most likely reject it to avoid adverse classification. Only in those situations where, from the bank's viewpoint, adverse classification is a better result than the bank foreclosing on the property, can such a plan be proposed.

There is a second type of classification used by the banks and the examiners to determine if the extended or restructured loan will be placed on an accrual or nonaccrual (cash) basis. A loan classified as nonaccrual means the lender can only count the interest on the loan as income to the bank when the interest is actually received. Banks wish to avoid this as the loan may then be listed as non-performing.

If "*...a loan that has been restructured so as to be reasonably assured of repayment and performance according to prudent modified terms [it] need not be placed in nonaccrual status. Therefore, for a loan to remain in accrual status, the restructuring and any charge-off taken on the loan must be supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be placed in nonaccrual status*." Accordingly, if the loan is extended or restructured at a current market interest rate with a payment schedule that reasonably supports repayment of the loan in full at the end of the extended term, the borrower's plans and projections for the property support such repayment, and the borrower has a demonstrated history and future path showing the ability to make regularly scheduled payments, the loan may maintain its accrual status even with the decline in the borrower's creditworthiness.

The borrower, in preparing its proposed plan, should devise an end result where the extended or restructured loan is classified as "***pass and is monitoring the credit***" or "***special mention***" and is kept in "***accrual status***". Unless the then current fair market value of the property is so bad that the lender will never recoup a substantial portion of its principal, the future expenses of the property will be a never-ending drain on the lender, or there are outside problems prohibiting or inhibiting the lender from foreclosing, such as significant environmental problems, a large prior lien, large unpaid taxes or costs to repair, the lender will usually strongly resist any borrower plan that results in the loan shifting to an adverse classification or nonaccrual status.

On the other hand, "if you don't ask, you don't get," and "you miss one hundred percent of the shots you don't take," a borrower may, if it believes it has a good read on its lender and the overall position of its loan, propose a plan knowing the lender will not accept it, but will act as a borrower-friendly starting point to negotiate a plan both sides can live with.

A borrower may only have one shot at its presentation. It must balance pushing for the best position versus making the lender think it is being played. Just the issuance of the 2023 Fed Policy Statement reinforces the idea that neither the Feds nor the bank want the bank to end up with numerous bad foreclosed properties. Once the bank forecloses, it locks in the least it can lose on the loan and takes the chance that such losses will increase by the future costs of ownership and selling the foreclosed property. Hence, the borrower knows the lender will be receptive to a good plan as the lender wants to avoid foreclosing and the risk of large unknown future losses.

However, the borrower must remember that it is fighting from a weakened negotiating position. The lender has the power to foreclose and wipe out the borrower's originally contributed equity let alone pursue the borrower or guarantor for a deficiency. Do not insult your lender's intelligence or aggravate your lender with a plan that makes the lender feel you are trying take advantage of them. Insulted feelings do affect negotiations.

Also, remember there is no default from a lender's point of view like a maturity default. A maturity default is generally death to a borrower and often results in a summary judgment in favor of the lender. With a maturity default, the lender holds all the cards, except if it wants to avoid foreclosing and owning the property for reasons such as large environmental or rehab cost issues.

A borrower must walk the fine line of pushing the best deal it can while at the same time treating its lender with respect and making the lender feel both confidence in the borrower and that the borrower is not trying to sneak one past them. I have been on many calls with lenders asking me, upon seeing the borrower's proposed plan, "What are these guys trying to pull?" Not a reaction a borrower wants to its proposed plan. Once a lender feels the borrower is trying to sneak some point past them or has not been truthful, the entire dynamic of the negotiations change.

Additionally, though a borrower wants to get the best deal it can, it should remember that the 2023 Fed Policy Statement clearly states that the repayment of the loan must be on reasonable terms that provide the lender with a reasonable probability of being repaid in full. Therefore, a borrower should not hobble itself with a plan the lender and examiners do not feel meets this standard. Otherwise, the lender will dispose of the borrower's plan and impose a solution not favorable to the borrower.

In trying to balance the above, we, at KRCL, have often sat with our borrower clients and assisted them in structuring ideas and by playing "Devil's Advocate." Since, in most of the initial meetings, the borrowers and lenders like to meet without attorneys to "keep it light" and non-confrontational, our attorneys will sit with and prep their borrower client to go through the plan to make sure it is presented in as reasonable a light as possible. We focus on preventing a client from walking into a meeting that results in the client's plan being summarily discarded and the lender replacing it with a draconian alternative because of its frustration with the borrower's initial unreasonable proposal.

Conversely, our attorneys, at KRCL, have often worked with their lender clients to assist the lender in reviewing and commenting on a borrower's proposal. A borrower should not assume the lender is asleep at the wheel or will miss an important point. All banks call in their law firms and a deep bench of other professionals and specialists to assist the lender in its review. It is a foolish borrower who underestimates the assistance a bank can tap into to identify an unreasonable plan for what it is. Quite the contrary, the bank, its attorneys and other professionals see these plans frequently and can quickly tell when a borrower is trying to sneak something by or take advantage of the lender. Again, not a good idea, as the lender's discovery will poison the negotiations and most likely lead to a result not favorable to the borrower.

About the Author

Charles Aster has a diverse real estate practice which includes not only working closely on the development and financing of a number of premier stadiums and arenas across America, but with over 40 years' experience in the financing (both lending and borrowing), acquisition, ground leasing, construction, leasing and sales of major office buildings, hotel groups and hotel projects, apartment complexes and shopping centers throughout the United States.

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