THE VALLEY'S TOP CHIEF FINANCIAL OFFICERS

CFO Workouts Are No Simple Exercise

By Keith Todd Zimmet

Today, Chief Financial Officers (CFOs) often find themselves taking on lead roles in unfamiliar settings. By some estimates, two-thirds of all commercial real estate loans maturing in the next five years currently exceed the value of the real property.

Many non-real estate loans are not much healthier. In these economically troubling times many companies operate with declining real and personal property asset values and in violation of financial covenants with their lender. Personal guaranties supporting commercial loans may be worthless. Nevertheless, all may not be lost for the business and under the right circumstances the CFO may be able to guide the company through a loan workout outside of bankruptcy.

The CFO must first determine whether the fundamental business of the company remains sound. If there is no foreseeable way to prevent financial losses in the future, neither borrower nor lender has any incentive to enter into a workout agreement. The two parties will likely negotiate an orderly liquidation of the company.

On the other hand, if a company has an otherwise successful business that suffers due to declining revenues and asset values caused by the recession rather than inherent problems with the business, the owners of the company will try to hold on, cut expenses, and survive until revenues and asset values return to historic, pre-recession levels. Often, the lender will be unwilling to "wait the recession out" and will seek to immediately enforce its remedies. But, when the value of collateral securing a loan falls below the outstanding loan balance, lenders may find themselves in a position where foreclosure is not the best alternative. Furthermore, California's "one form of action" and "anti-deficiency" rules may provide additional incentives for lenders to enter into loan workouts.

If the lender is a traditional bank that holds and services its own loans, the CFO will be working with the bank's workout group.

In many cases, the first step is negotiating a forbearance agreement, whereby the bank agrees to forbear or delay enforcing its remedies in exchange for certain new performance requirements (e.g., new financial ratios and covenant requirements). Since lenders are unwilling to give up such immediate enforcement rights if there remains any possibility that the borrower will bring a claim against the lender, the CFO should expect the bank to insist upon a full release of any claims which the borrower may have against the bank through the date of such forbearance agreement.

Absent alternative collateral or significant guaranties from more solvent parties, traditional lenders often renegotiate interest rates, implement an interest only period, convert regularly scheduled principal payments to principal payments conditioned upon the occurrence of certain events, and even agree to a reduction of the principal loan balance.

But as any CFO can tell you, many loans of the past decade, especially real estate loans, are part of securitized pools of loans held by special purpose entities instead of traditional banks.

In such a case, the CFO would work not with the actual holder of the debt, but rather with a trustee on behalf of the bondholders. Furthermore, these trustees often contract with a loan servicing company to manage the loan, so that the CFO could be dealing with the loan servicer operating on behalf of the trustee, who acts on behalf of the bondholders. The ultimate holder of the debt may not even know that a particular loan has problems. The powers of trustees under these securitized loans are strictly governed by the terms of a lengthy Indenture Agreement, and often such agreements do not provide the trustee with much flexibility. As a result, loan servicers acting on behalf of trustees are also restricted.

Still, because recourse on these loans tend to be limited to the pledged collateral, immediate foreclosure could result in substantial losses to the bondholders. Therefore, more and more trustees are willing to enter into workout arrangements with their borrowers.

Given these restrictions on the trustee, the CFO should not expect the loan servicer to agree to any immediate reduction on the existing debt. Rather, workouts in these securitized transactions often result in dividing the existing loan into two or more "tranches", with different repayment terms.

For example, assume an original loan for $25,000,000 amortized over a set period of time. If the collateral for such loan is valued today at only $20,000,000, the lender could divide the loan into two separate tranches. Under this example, Tranche 1 might be $20,000,000, and would continue to be amortized and repaid over the same period of time as originally structured. Tranche 2 might be $5,000,000, and would continue to accrue interest; however, no payment of principal or interest would be due under Tranche 2 until maturity. This could solve the borrower's immediate cash flow problems, while preserving the lender's rights should the collateral increase in value post-recession.

Since recourse on the loan remains limited to the collateral, both borrower and lender benefit from this restructuring. Often these restructurings will include new modified financial covenants that the CFO and the loan servicer will negotiate.

If the Chief Financial Officer is upfront and honest with the lender, he or she may find that the company and the lender have a mutual interest in working together to resolve their respective issues.

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