

Best Practices in Commercial Loan Modification

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Best Practices in Commercial Loan Modification

The recovery of the economy has been unexpectedly slow, and it has affected both consumers and commercial businesses. As loans mature and business owners experience trouble with their payments, they are seeking relief in the form of commercial loan modifications. For owners with distressed loans and lenders who cannot afford the multitude of foreclosures dropping in their laps, loan modification offers a solution that helps those on both ends of the agreement. However, making a loan modification work for a particular lender depends heavily on previous experience in modifying commercial loans. Many lenders without this experience are hiring outside consultants and sending their best professionals back to school or to detailed seminars about the process. The following guide is intended as a primer for lenders who are inexperienced with commercial loan modification, and it allows them to go into a full class armed with relevant background information.

What Is a Commercial Loan Modification?

When business owners fall behind on loan payments or have reason to believe that they will soon default, they may approach their lenders requesting for modifications to the terms of their loans that will make the payments more affordable and provide an alternative to foreclosure. Often called a commercial loan workout, a loan modification is a comprehensive solution

with several potential benefits, including the temporary deferment of payments, interest-only payments and late fee waivers. If the business owner cannot receive a permanently lower payment, then it is still possible to receive temporary assistance until revenue can be increased enough to make the regular payments.

In some cases, a lender may request additional collateral in the terms of a modification, and it is not unknown to ask for a new title insurance policy to be purchased. Lenders must be diligent in their efforts at finding a solution that works in their favor but also prevents the borrower from foreclosing. At the same time, lenders walk a fine line and must ensure that no code violations or taxation issues arise. In order to avoid these pitfalls, some lenders may actually lend commercial property owners additional funds to help keep their businesses afloat and running smoothly.

Lender Goals

The primary goal of any lender entering into a loan modification agreement is to get the loan repaid on time without having to foreclose on the property. While foreclosure can help a lender partially recover the unpaid principal of a loan in default, the process is time consuming and expensive. For the most part, lenders are not in the business of property management, and foreclosure of a commercial loan puts a sizable chunk of property directly into their hands. Additional expenses may be incurred after foreclosure if the property cannot be resold quickly.

A commercial loan modification may prevent lenders from having to reclassify an existing loan as a distressed, or bad, loan. Once the loan is reclassified as distressed, it forces a lender to put up additional capital in reserve. However, the flexibility and the acceptable terms of a loan modification often depend on the type of lender and how the loan originated.

When deciding upon the acceptable terms of a commercial loan modification, most lenders can determine fairly quickly the value of the property and whether the borrower will be able to repay the loan, which are two of the most important factors to consider in a new modification. If the situation does not seem to be salvageable, the lender may have no option but to let the loan go through foreclosure and collect as much as possible from the sale of the property. In making this determination, most lenders put borrowers requesting modifications into one of two categories. The first category is borrowers who add irreplaceable value to their properties through hard work. This can increase the properties' equity and may lead to increases in revenue for the borrowers. The second category is borrowers who either do not add any value to their properties or who are working at angles that do not include fully repaying the loans.

Unfortunately, many lenders are so overworked that this important decision on categorizing borrowers is often made without the benefit of scientific studies, and the decision may be made based only on first impressions. A full study is necessary

because many borrowers can be labeled as holding bad loans simply because their initial presentations are lacking. In other cases, an impressive presentation may be able to effectively mask an egregious borrower. This is not to say that a personal impression should not be considered, but it should be tempered with raw data and follow up reports.

Once a lender agrees to modify a commercial loan, four new goals are established:

1. The legal rights and remedies available to the lender are improved should the borrower default on the loan in the near future.
2. The collateral held for the loan is preserved or improved.
3. The borrower is not given any additional legal rights or defenses.
4. The amount collected from the borrower after the modification is more than what could be collected through foreclosure.

Reviewing the Documents

One of the first steps for a lender in negotiating a commercial loan modification is to review all of the existing loan documentation. It is preferable that the documents are reviewed by at least two people: the lender and an attorney. An attorney may be able to notice points or flaws that the lender missed during the initial review. If the borrower can discover flaws in the documentation that are not found by the lender, then it can create a serious imbalance in leverage during negotiations. Instances have occurred where

seemingly minor flaws have allowed borrowers to take control of properties immediately without fully repaying their loans.

A thorough review of the documentation should include all of the following:

- The original documents should be read completely instead of relying on summaries.
- Documents should be reviewed for past modifications or changes.
- Documents should be screened for common errors.
- The collateral on the loan should be as described in the documents.
- Environmental documents should be reviewed.
- Documented changes in the circumstances of the borrower need to be scrutinized.
- Changes in any laws pertaining to the loan should be determined.

Reviewing the Business

After the loan documents have been reviewed, the actual business should be evaluated. This is usually accomplished with the help of a professional commercial property appraiser. The appraiser can determine a fair value for the property but must be willing to testify in court. In addition to evaluating the business and the property physically, the business's financial statements should be reviewed. It is especially important to note how the funds from the loan were used or continue to be used.

Before Negotiations

Several steps should be taken by a lender before entering into loan modification negotiations. In fact, most of the top lenders require that borrowers seeking loan modifications enter into pre-negotiation agreements. This type of agreement limits what a borrower can do with any information obtained during the course of the negotiations. If borrowers are allowed to use this information as evidence in court, it could provide them with leverage over their lenders. This agreement also protects a lender's right to back out of the modification at any time before it is finalized.

In some circumstances, it is beneficial for the lender to put pressure on the borrower before negotiations take place. This pressure may be in the form of the initiation of foreclosure proceedings. This often hastens the process and saves the lender money after the modification is complete. In addition, it saves time for cases where negotiations are unsuccessful and foreclosure ends up being the only option.

Negotiating a Commercial Loan Modification

Lenders very rarely enter into loan modification negotiations without the help of experienced attorneys, especially when it comes to commercial loans. Negotiations are usually accomplished by using temporary workout documents. These documents are not enforceable and provide both parties with a safe medium to hash out any differences in acceptable terms and

conditions. Most lenders allow the borrowers to provide the temporary workout term sheets. When lenders make the first move, it puts them at risk of being accused of overstepping their legal boundaries and giving orders to borrowers that may not be appropriate.

Several issues should be addressed during loan modification negotiations, and the final goal is to agree upon the following factors:

- Timing and amount of payments
- Interest rate
- Additional collateral
- Tax issues
- Forgiveness of interest and/or fees

Successfully Closing a Loan Modification

When the final terms have been agreed upon by both parties, they must be formally

documented. During documentation, new issues may arise that are cause for further refining the modification. The documentation should fully state the basic terms of the modification in addition to the modified terms of the loan. The borrower must agree to meet all of the terms and refrain from any legal claims concerning the modification once it has been implemented.

It is also important to obtain the consent and signatures of any secondary guarantors or to officially exclude them from any interest in the modified loan. After the modification is signed, the documents are filed and copies are given to all of the pertinent parties.

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