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COMMERCIAL REAL ESTATE

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LOAN WORKOUTS
PART 3—CALL TO ACTION

It's 7:00 AM. Someone needs a wakeup call. It is still early, but getting late.

These are tough times, no doubt about it. But just as investors, lenders and developers deluded themselves over the past several years into believing the good times were here to stay – so, too, are they misreading the future now.

NEWSFLASH! This market will hit bottom. This market will turn. The credit freeze will thaw. The commercial real estate market will rise again.

The question is: How are we going to position ourselves for the balance of this economic cycle?

Certainly, to get to the other side we have to survive the downside. But, really, we need to look past the ground immediately in front of us. We need to raise our eyes to the economic horizon to see where we are headed, then plan to get to there, and move beyond it.

We don't need a crystal ball to see the future. Those of us who have been in this industry for thirty years or so have been through this before – at least a couple of times. We know the cycle. We need to heed the lessons history should have taught us. This is no time to pull the covers over our collective heads and hide – hoping we will soon wake up from this horrible dream.

Right now the commercial real estate market is stalled. We all know that. Vacancy rates are climbing. Credit is tight. Loan defaults are rising. Borrowers and lenders are stressed. There is a general uneasiness about where we are and where we're headed. Deal flow has dropped to a mere trickle.

Our industry is so constricted right now, an eerie calm has settled upon us.

Borrowers are in default, but lenders are not aggressively seeking to take control of their collateral. Let's face it, in this market, what is our lender going to do with our project that is any better than what we are doing with it? Sell it? To whom? And on what terms? Appoint a receiver to take possession and control? If professional property investors and managers with an equity stake can't make these projects cash flow, is it reasonable to expect that a foreclosing lender will fare any better?

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(Continued on page 2)

What about their other choice, which is to enforce personal loan guarantees? How much of the income stream and net worth that gave those guarantees value is still available?

No. The answer right now is loan modification and loan restructuring. Most banks accept that a modified loan yielding a lower return but receiving regular payments is better than a non-performing loan receiving no payments.

BORROWERS TAKE NOTICE: As bad as this down economy is, it presents a whole host of opportunities to modify loans in a way that will make these troubled projects more profitable on the other side of this cycle. What is possible depends upon variables inherent to each loan and each project.

There are any number of potential workout solutions to which a borrower and lender may avail themselves. No two loans and no two projects are exactly the same. One solution will not fit every circumstance. Each solution must be tailor made to meet the respective, and often conflicting, needs of the lender and borrower.

Why would a lender agree to any of this? Certainly not because they feel compelled to help their borrowers. No, there is nothing altruistic about it. Plain and simple, it's because lenders know that in this economic climate they are likely to end up recovering more through a negotiated restructuring than they will recover if the borrower simply gives up and walks away or files bankruptcy and sells the property free and clear of all liens, claims and interests through a pre-packaged sale pursuant to Section 363 of the U.S. Bankruptcy Code. Now, more than ever, lenders recognize that cooperating with borrowers to restructure a distressed loan in a way that keeps the borrower operating the property may be the only sound and prudent choice they have to maximize recovery.

Borrowers are missing the opportunity they now have to negotiate with their lenders to achieve loan workouts that can give the borrower a realistic chance to get out of this mess. Lenders are willing to deal now, to avoid major write downs and to avoid having to carry defaulted, non-performing loans. For many borrowers, any indulgence a lender gives to forestall foreclosure seems a blessing. Financially distressed borrowers are only too happy to accept these stop gap solutions to buy temporary peace.

Many distressed borrowers are failing to take aggressive steps to benefit from opportunities that exist. The certain outcome of this inaction is that borrowers are setting themselves up for future loss. Borrowers are simply misreading the patience many lenders are currently showing.

It is true that many lenders are being cooperative by extending loan maturity dates and lengthening default cure periods. Borrowers appear to believe these lenders have found a heart. Borrowers are thankful for the 30, 60, 90 or 120 day extensions they are receiving. To obtain these brief extensions, some borrowers are draining cash flow or equity from other projects or investments to keep interest payments current, which is often the only requirement their lender is insisting upon during these troubled times as a condition to granting loan extensions. To hear many borrowers talk, they are convinced their lender will continue to work with them until the market turns and recovers, when the borrower and lender can both return to Xanadu and live happily ever after.

(Continued on page 3)

Ring! Ring! Ring! This is a wake up call. It is NOT going to happen that way. Unless we act now we will lose this opportunity to save our property and salvage our investment.

Here's how I see it:

There is not going to be any single event that will cause a reverse Lehman effect, resulting in a sudden loosening of credit and prompt rebound of the commercial real estate market. Consequently, after the economy has hit bottom and begins to turn upward, recovery is likely to take place at a slow pace over an extended period.

It is an absolute certainty that the market will eventually hit bottom and turn upward. This is as sure to happen as Annie singing "the sun will come out tomorrow". You can bet your bottom dollar that the commercial real estate market will rise again. Unfortunately, it will not happen overnight. Once deal flow starts to develop, property values will begin to rise. Perhaps counter-intuitively, this is where distressed borrowers who have not negotiated a meaningful loan workout agreement in advance will get hurt.

Here's why:

Assume a project was worth $25 million before the current crash, and has an outstanding mortgage of $20 million, but today the property would fetch only about $14 million. The investor started with equity of $5 million. Today, the project is upside-down by $6 million. Some borrowers seem to believe that when the market turns and starts going up again, lenders will continue to grant short term extensions into the future until the project value fully recovers so the borrower can regain its equity. The reality is, it is not going to happen that way.

Lenders are not going to wait around for the property value to rise to $25 million as it was before the crash if they don't have to. They won't have to unless a long term extension is negotiated now.

As the market picks up and property values start to increase, the borrower is destined to lose out. As soon as a third party comes along and lets the lender know it is willing to buy the project or the loan for anywhere near the $20 million balance of the loan, the borrower has lost all of its bargaining power. The lender will not likely grant that next 30, 60, 90 or 120 day extension. Instead, the lender will very likely declare a default and force a sale for an amount necessary to satisfy the loan, but no more. That is all the lender cares about. The lender will get out when it can. It will not take the chance that the market may drop again. If the borrower has failed to act to protect itself while it is in a position to do so, the borrower will have lost any opportunity to recover its investment. Even worse, the Borrower may have, in the meantime, drained other investments to keep interest payments current for naught.

In order for borrowers to protect themselves they need to get to the negotiating table now, while lenders still have something to lose. Now is the time borrowers need to act – while lenders are stressed and fearful and motivated to deal.

Why are borrower's holding back?

There are a variety of reasons cited by borrower's for not aggressively seeking to renegotiate their loans right now to protect them in the future. Many are simply in denial or in a state of psychological

(Continued on page 4)

paralysis from the shock caused by the swift and largely unexpected decline of our economy in general, and the commercial real estate and credit markets in particular.

Others are holding back through fear that if they start actively discussing the topic with their lender, their situation will come to the forefront in the lender's mind and the lender may commence aggressive action to collect. This reasoning seems to be founded on the notion that maybe the reason lenders are not aggressively pressing borrowers for payment to forestall enforcement and foreclosure action is because lenders are so busy putting out other fires they don't have time to focus on this one.

It is highly unlikely that this is the dynamic at play. As mentioned above, the reason lenders are not proceeding aggressively at this time is because the market is no better for them than it is for us. They don't want to own our projects and get stuck with the headache of managing projects that are not cash flowing and cannot be sold. They are biding their time, waiting for economic conditions to improve so they can get out whole, or close to it.

The other reason I hear from borrowers is that negotiating a successful loan workout requires competent legal counsel skilled at workout negotiations. The borrower is already financially distressed. Even the thought of incurring the additional expense of hiring a lawyer is almost unbearable.

The obvious defect of this reasoning is that it is short-sighted. If resources can be reallocated now to work out a long term solution, the chance of pulling out of the current financial death spiral increases dramatically. If borrowers continue living on borrowed time with only short term, stop gap solutions, it is a virtual certainty they will ultimately lose their investment and, perhaps, remain liable to pay additional funds under their personal guaranty.

To say the least, this is being penny wise and pound foolish.

I know. This may sound like a tremendously self-serving statement coming from an attorney who represents borrowers in loan workouts. A point well taken. But consider this: I am not saying you must hire my law firm. While I genuinely believe my firm offers a unique value proposition that may serve you well, hiring my law firm is not the point. Really, you just need to hire someone – anyone – who fully understands the issues, understands the possible workout scenarios and who has experience resolving conflicts with lenders. If you have worked with other counsel who can do this, then hire them if it makes you feel more comfortable. Just get started. The longer you wait, the worse it will get.

If you are interested in learning more about the value proposition Robbins Salomon & Patt, Ltd. offers for loan workouts, feel free to contact me. I will put it in writing.

In all events, we wish you the best of luck. Like it or not, we are all in this together until our industry recovers.

Over the coming months, exercise caution, be safe, and do what you can to position yourself to prosper when the market rebounds. Keep the faith – it will rebound. We want to see you on the other side. *Until then . . .*

Thanks for listening,

Kymn