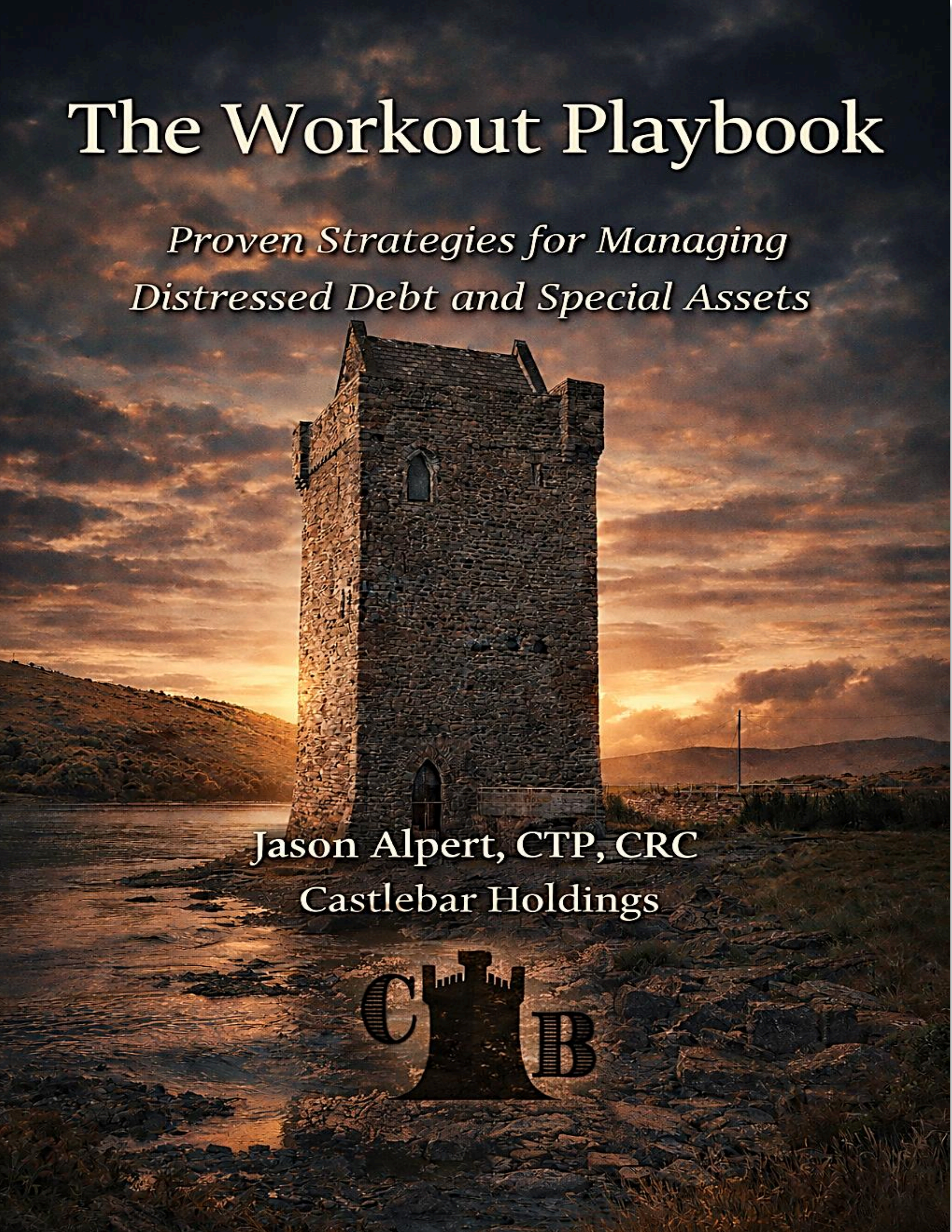
The Workout Playbook

Proven Strategies for Managing Distressed Debt and Special Assets



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Foreword – Edition 4 – January 2026

The banking industry continues to operate in an environment marked by economic uncertainty, evolving regulatory expectations, and increasing complexity in credit structures. As a result, the effective management of distressed debt, special assets, and problem loans remains a critical competency for financial institutions. Bankers today must balance speed, judgment, and discipline while navigating workouts that preserve value and protect long-term relationships.

This fourth edition of the Workout Playbook builds on prior editions and reflects additional insights gained through ongoing advisory work, industry developments, and recent market cycles. It is intended to serve as a practical, field-tested resource for bankers responsible for identifying, managing, and resolving troubled credits. The materials compiled here draw from my published articles, training materials, and my foundational Workout seminars, updated and refined to reflect current conditions and best practices.

The objective of this handbook remains straightforward: to provide bankers with a single, reliable reference that spans the full lifecycle of a problem loan–from early warning signs and risk assessment to restructuring strategies, enforcement decisions, and exit planning. Rather than offering purely academic discussion, the focus is on practical applications, judgment calls, and real-world solutions that arise in the course of managing special assets.

Whether you are a seasoned workout professional, a special assets officer, or a relationship banker encountering distressed situations with increasing frequency, this Workout Playbook is designed to support informed decision-making, disciplined execution, and improved outcomes. I hope this fourth edition continues to be useful tool in your day-to-day and trusted reference as credit conditions evolve.

🏛️ Workout Playbook – Executive Summary & Table of Contents

SECTION I – Professional Education Decks

📘 Workout 101: Essentials and Strategies to Maximize Value in Commercial Loan Workouts

This foundational deck provides commercial lenders, portfolio managers, and workout teams with a step-by-step approach to navigating troubled credits. It introduces triage principles, communication strategies, and recovery pathways that maximize bank outcomes while preserving client relationships. Ideal for banks looking to sharpen their response as credit quality softens.

📕 Workout 201: Case Studies in Distressed Debt & Resolutions

A high-impact follow-up to Workout 101, this deck walks through real-life restructurings across C&I, CRE, and sponsor-backed loans. These case studies highlight how banks leveraged tools like note sales, discounted payoffs, and turnaround consultants to resolve risk. Perfect for executive discussions on portfolio strategy and Credit Committee training.

▨ Workout 301: A Survey of Alternative Collection Strategies

SECTION II – Published Articles

I. **Early Warning Signs & Borrower Behavior**
Identifying trouble before it becomes a loss

Don’t Let the Sins of Your Client Be Deadly to Your Bank
The RMA Journal, Feb 2017

Some borrowers fail because of cash flow. Others fail because of character. This article identifies recurring behavioral red flags—evasion, entitlement, and denial—that often foreshadow a deeper credit event. It encourages lenders to recognize how the 'seven deadly sins' map to borrower conduct, offering a lens beyond the numbers. In an era of declining covenants and relationship lending, these lessons are more relevant than ever.

Non-Profits Behaving Badly
The RMA Journal, July / Aug 2017

Nonprofits may be mission-driven, but they're not risk-free. This article outlines governance failures, misallocated funds, and weak controls that frequently lead to credit surprises. It encourages bankers to apply the same level of underwriting rigor to nonprofit borrowers as they do to for-profits. The stakes are often higher when reputational risk and regulatory scrutiny enter the picture.

Early Warning Signs: Harbingers of Loan Distress and Default
The RMA Journal, Sept 2022

From delayed financials to sponsor apathy, this article lists common but overlooked signs of distress. A helpful early detection tool for any banker managing a stressed portfolio. Spotting these red flags early can make the difference between a successful restructure and an unanticipated charge-off.

The Workout Window – (The 5 D's) *The RMA Journal*, June 2024

The 5 D's—death, disability, drugs, divorce, and disagreements—often precede financial collapse. This edition helps bankers spot the warning signs early and ask the tough questions needed to protect repayment.

The Workout Window – *The RMA Journal*, February/March 2024

This issue features three challenges that will be familiar to any seasoned banker: mounting risk in office-backed CRE, a borrower perpetually late on payments, and a drawn revolver with no recent contact. Each scenario reveals key tactics—from enforcing updated financials to preparing a graceful but firm workout handoff.

II. Workout Strategy, Decision-Making & Value Maximization

Choosing the right path when distress is unavoidable

Leveraging Your Workout Department
The RMA Journal, June 2019

Workout groups aren't just for defaults. This article argues for early involvement of special assets teams in stressed credits—highlighting value creation, early detection, and internal collaboration that improves bank outcomes. For banks seeing rising delinquencies or a CRE repricing wave, this approach may be your best defense.

How NPV Helps in Choosing the Best Workout Option for a Distressed Loan
The RMA Journal, May 2024

This piece introduces net present value modeling to compare workout paths—from discounted payoffs to litigation—ensuring decisions are data-driven and aligned with recovery goals. It arms bankers with a quantitative framework for justifying decisions internally and with regulators.

Helping Borrowers Help Themselves: The Case for Turnaround Consultants
The RMA Journal, June/July 2025

Turnaround consultants can revive borrowers on the brink. This article makes the case for their use, offering examples of how third-party experts bring credibility, discipline, and sometimes survival. Particularly useful for banks navigating time-sensitive workouts with management teams who need external accountability.

III. Commercial Real Estate (CRE) Distress & Portfolio Risk

Managing repricing, regulation, and reality

CRE Loan Distress: Spot the Symptoms, Diagnose, and Treat Problem Loans
Abrigo.com, March 2024

This article delivers a clinical approach to distressed commercial real estate. It walks readers through a diagnostic process—spotting early symptoms, evaluating borrower options, and determining whether to restructure or exit. A timely Playbook for banks facing CRE headwinds.

Thinking of Reducing Your Bank's Exposure to CRE?
The RMA Journal, June/July 2024

CRE repricing and regulatory scrutiny are driving banks to de-risk. This article outlines tactics for exiting loans strategically and obtaining the best value for the bank's shareholders. Ideal for Credit Committees and CRE teams exploring portfolio optimization strategies without alienating clients or inviting reputational risk.

The Workout Window – (Environmental Issues), *The RMA Journal*, *August/September 2024*

Environmental issues can freeze a loan in its tracks. This column outlines how to respond swiftly to contamination concerns, preserve value, and protect your legal standing when the dirt becomes dangerous.

The Workout Window – (Multifamily Stress) *The RMA Journal*, *October/November 2024*

Multifamily isn't immune. This edition unpacks how softening cash flow, deferred maintenance, and borrower distraction can upend a seemingly safe CRE deal—and how to intervene before it matures into a charge-off.

The First Loss Is Often the Best Loss: A Disciplined Approach to Troubled CRE Loans
Law.com / Business Daily Review, November 2025

This article argues that early recognition and decisive action are essential in managing troubled CRE loans. It emphasizes discipline over delay, advocating for objective diagnosis, transparent borrower engagement, and timely restructuring or exit. A pragmatic framework for lenders seeking to preserve capital and long-term portfolio stability amid CRE stress.

IV. Revolving Credit, C&I Stress & Liquidity Risk

Where problems accelerate fastest

The Workout Window – (Tariffs, Supply Chains & B2B Stress)
The RMA Journal, June 2025

This column dives into a timely and complex B2B lending challenge: managing a distressed borrower caught in the crossfire of tariff uncertainty and weakening consumer demand. A specialty component manufacturer facing an over advance, supplier payment delays, and aging A/R triggers a real-time case study in proactive workout strategy. Jason outlines when to downgrade and transfer to special assets, how to structure a thoughtful default and forbearance process, and where to bring in a turnaround consultant to preserve value. Beyond tariff cost concerns, the piece highlights a growing but underappreciated risk—supply availability—as a looming threat to borrower viability. An essential read for bankers managing revolving lines with stressed borrowing bases or exposure to global supply chains.

The Workout Window – (Merchant Cash Advances)
The RMA Journal, September 2025

This issue examines the growing threat of merchant cash advances infiltrating bank credits. Through a real-world workout scenario, it highlights how MCAs drain liquidity, cloud collateral, and accelerate borrower distress. The article outlines concrete steps, early downgrade, cash dominion, and decisive engagement to protect the bank before an MCA turns a manageable credit into a crisis.

The Workout Window – (A Lender Who Inherited a Troubled Loan Asks, "Should We Stay or Should We Go?")
The RMA Journal, December 2025

This article tackles a common post-merger challenge: inherited C&I credits that no longer fit current policy or risk appetite. Using a lower middle-market manufacturing revolver as the case study, it explores how to balance borrower cooperation against structural weakness, over-advances, and leadership skepticism. The piece introduces dual-track strategies – restructuring while preparing for an orderly exit—and highlights the growing role of private credit as a viable take-out when banks need resolution without chaos.

The Workout Window – (A Field Exam Uncovers a House Built on Sand)
The RMA Journal, January 2026

A field exam reveals how seemingly compliant borrowing bases can mask deeper control and reporting failures. This article walks through the warning signs uncovered during diligence, the risks of relying on flawed collateral data, and the decisive steps lenders should take once trust erodes. For banks managing asset-based credits, it underscores why early scrutiny and swift workout engagement are critical to preserving value.

V. Exit Strategies, Legal Tools & Capital Alternatives

Knowing when – and how – to get out

Note Sales: Achieving a Win-Win
The RMA Journal, Aug 2022

This guide lays out the strategic use of note sales to exit distressed credits. It details execution pitfalls, timing nuances, and how to position note sales as proactive credit solutions. A compelling option when restructure isn't feasible but a forced recovery would damage the bank and borrower alike.

A Banker's Guide To the Bankruptcy Code's New Subchapter V
The RMA Journal, Aug 2023

Subchapter V reshaped small business bankruptcy—and this article helps banks navigate it. It outlines plan timelines, cramdown changes, and lender rights under the streamlined process. A practical primer for credit officers and legal teams facing an uptick in filings from middle-market borrowers.

Core Concepts: The evolution of Private Credit and What It Means for Banks
ProSight Financial Association, November 2025

Once a niche solution for distressed borrowers, private credit has evolved into a $2 trillion market that increasingly overlaps with traditional bank lending. This article examines how private credit compensates with and sometimes complements—banks, particularly in stressed and transitional situations. It explores regulatory concerns, capital stack dynamics, and why private credit can serve as both a threat and a pressure-relief valve for bank balance sheets. An essential read for bankers navigating exits, refinancings, and secondary-market solutions.

VI. Case Studies, Cautionary Tales & Relationship-Driven Workouts

Where nuance, diligence, and judgment matter most

Walking the Land Leads to a Spooky Surprise
The RMA Journal, April/May 2023

In this Halloween-worthy cautionary tale, a seasoned banker discovers the terrifying cost of skipping the fine print. What begins as a promising deed-in-lieu resolution on a defunct car dealership unravels when a mysterious line in the appraisal—"PETCEM"—leads to the discovery of a forgotten pet cemetery... with a buried human. From legal ambiguity to reputational landmines, this article shows why walking the land and reading *every* page of the appraisal can make or break a deal. A must-read for bankers who think they've seen it all—until the cemetery gate creaks open.

The Workout Window – *The RMA Journal April/May 2024*

What happens when a borrower demolishes a property without notice? Or when an electronics wholesaler's inventory turns obsolete? Or a church can't recover from the loss of a key pastor? This issue delivers practical advice on managing reputational risk, collateral impairment, and relationship-based accounts under stress.

The Workout Window – (Microbrewery Case) *The RMA Journal February/March 2024*

A borrower riding the microbrewery boom is now losing fizz. This piece explores how branding hype can mask fundamental flaws, and when a lifestyle loan becomes a liability.

The Workout Window – (Public-Private & Grant-Funded Borrowers*) The RMA Journal April/May 2025*

Federal grants don't guarantee repayment. This edition explores risks tied to public-private borrowers whose funding delays and budget constraints are increasingly destabilizing their credit performance.

SECTION III – Castlebar Holdings

About the Author

What we offer

Section I:
Professional Education Decks

Workout 101: Essentials for Successful Loan Workouts

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Agenda

- Credit deterioration and Early Warning Signs
- Relationship transfer
- Triage
- Lender Liability
- Make Prognosis
- Develop Strategy / Action Plan
- Net Present Value Analysis
- Modification / Restructures
- Litigation
- Bankruptcy

Creditors' Rights

Problem Loan Resolution / Special Assets Department / Workout / Loan Adjustment / Credit Management

Despite differing jargon, it is essentially resolving problem loans by either:

(i) limiting liability & losses
(ii) maximizing recovery to shareholders
(iii) restructuring assets to upgrade risk rating and free-up loan loss reserves to reinvest (make more loans)

50% Finance / 50% Legal / 50% Psychology

Credit Deterioration

Origination of Problems

The 5 C's of Credit = Character, Capacity (Cash Flow) Capital, Collateral, Conditions

Majority of loan "failures" derive from following:

- Macro factors or "force majeure", i.e. COVID / Tariff War
- Faulty Underwriting
  - Failure to adhere to Five C's of Credit
    - Character
    - Capacity (Cash Flow)
    - Capital
    - Collateral
    - Conditions
- Lack of Due Diligence
  - Failure to understand business model / primary source of repayment / industry or management team.
- Poor Execution
  - Weak documentation and / or legal advice. Failure to properly book or monitor appropriately

Early Warning Signs

Missed or Late Payments
Overdrafts
Failure to pay Taxes, Insurance, or Maintenance
Stretch of Trade or Merchant Cash Advances (MCA's)
Current Asset & Liability growth (extended cash conversion cycle)
Over-advances / non-revolving debt
Failure to meet informational delivery deadlines (financials)
Declining trends / declining operational performance
Failure to meet financial covenants
Lawsuits / Notice of Lien(s)
Avoiding Communication
The 5 D's of Distress*

*5 D's - Death, Divorce, Drugs, Disability, Disagreements
Proactive monitoring = enhances resolutions prospects

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Make Diagnosis

Consider transfer once Bank determines that either

- (i) an increased probability of future non-performance (risk rating downgrade)
- (ii) an event of default has occurred (payment / technical)

Benefits to Bank shareholders

- Arms length dealing with customer (Client / Borrower / Debtor)
- No preconceptions regarding credit / documents
- Ability to forecast and manage risk in portfolio

Triage

Obtain credit file and all correspondence from Bank and Borrower.

- Meet with Former Banker (if possible)
- Review material email correspondence between Bank and Borrower, look for any "smoking guns":
  - Bank commitments, opinions, recommendations.
- Be careful with email, all is discoverable in litigation. Think twice before hitting send.
- With tough conversations, best to keep minutes and follow up with email to customer to get on record. Another best practice is to have a witness or second representative to corroborate.

Obtain all legal documents associated with loan including all subsequent amendments as well as pre-closing correspondence (commitment letters can survive closing)

REVIEW LEGAL DOCUMENTS THOROUGHLY

- Do not rely solely on attorneys, must review and understand as they will be the "Bible"
- Ensure that all essential documents are properly executed and recorded.
  - Correct legal descriptions, proper authorities, adequate covenant definitions.
  - Does everything match up with credit package and how we underwrote / mitigated for risk?
- Determine what (if any) events of default have occurred and the proper rights and remedies afforded to the Bank

Lender Liability

<u>Loan + Duty *x* Breach = Lender Liability</u>

• Loan	All Types
• + Duty	Contract, Common Law, Statutory
• *x* Breach	Act or Omission by the Lender
• = Liability	Damages: Compensatory & Punitive or regulatory sanctions

- Don't exacerbate the situation, mitigate the risk going forward
- Be mindful of "Course of Dealing" with the Borrower. Actions speak louder than words (in the contract)
- Be extremely careful when acting as customer advocate / trusted adviser. Bank cannot appear to be directing or demanding how customer run their business.
- Maintaining customer's privacy is paramount. Get written approval prior to discussing anything with customer's reps / employees. Any outside party, make sure to have NDA / CA executed.

Make Prognosis

Determine positions of strength / weakness of Bank

Determine if collateral position is perfected and accessible (perfected mortgage, title claims, liens, UCC-1 recorded, etc). Have Landlord Lien Waiver in place for inventory / equipment.

Re-underwrite the credit

Obtain current financials as allowed ASAP (if Borrower willing to work with Bank)

Conduct proper due diligence

- Meet (in person if possible) primary principal
- New Appraisal
- Inspect collateral
- Material Changes to primary principals' condition, financial or otherwise (divorce, other litigation, loss of primary customer base, arrest).
- Outside research: Google, Bing, Lexis Nexis, LinkedIn / Facebook, Yelp, ChatGPT

Determine if EXIT or RETAIN relationship for Bank (designation is fluid)

Develop Plan of Action

RUN ON CONCRETE, WALK IN QUICKSAND – DON'T PUSH A BAD POSITION, WEAK DOCUMENTATION, OR UNPERFECTED COLLATERAL

BASED ON RETAIN OR EXIT DESIGNATION DEVELOP THE PROPOSED WORK OUT STRATEGY

IF BANK HAS PERFECTED POSITION AND COLLATERAL BASED ON DOCUMENTS, THEN DETERMINE BEST RESOLUTION SCENARIO BY RUNNING NPV ANALYSIS.

Net Present Value Analysis

- Run NPV comparing different feasible scenarios and reasonable / conservative assumptions
  - Foreclosure litigation / Stipulated foreclosure / Deed-In-Lieu
  - Discounted Payoff / Short Sale
  - Note Sale (always at discount relative to legal balance if not collateral value)
  - Various work-through scenarios
    - Modification (can vary widely based on repayment terms – accelerated amortization / duration)
    - A/B/C Note Restructure (if going to right size based on CF/collateral and forgive portion of debt – cognizant of accounting categorization)

NPV Analysis -- Assumptions

- Scenario 1 (Note Sale)
  - NPL amount outstanding -$1MM
  - discount rate – 20%, 3 months to realize
  - no costs and expenses

- Scenario 2 (Foreclosure)
  - NPL amount outstanding $1MM
  - discount rate – 20%, 26 months to realize
  - AV– $1MM
  - net collateral sale proceeds - $900M
  - Litigation, appraisal, PCR, environmental, FPI, delinquent RE taxes, remediation expenses - $300M
  - To simplify -- all cash inflows & outflows occur month 26

NPV Analysis (cont.)

Scenario 1

Note sale @ 50%

NPV = $478M

$500M

3 months

Scenario 2

Litigation, foreclosure, collateral sale

NPV = $404M

$900M*

26 months

*net collateral sale proceeds sale -- excludes $300M foreclosure and related expenses – see assumptions

Implement Plan of Action

All things being equal, select scenario which provides highest NPV, as it will accrue most benefit to shareholders

However, benefit of analysis is that it will help underscore several different options to resolve situation and help craft structure of terms / settlement amounts

Important benefit of multiple equivalent options is that provides invaluable insight to counterparty's motivation / desires / psychology in workout process

NPV analysis is fluid based on changing facts / circumstances / willingness of counterparty to accept different scenarios and options

Modifications / Restructures

- Consider if it improves the Bank position at present
  - Obtain cash pay down, additional collateral, extra guarantee, or even information (could be valuable in future discovery)
  - Should be bona fide quid pro quo
  - Aim for a Win / Win
- If RETAIN, consider long-term accounting affects of restructure (TDR, accrual status etc)
- Any documentation executed between parties (extension / renewal documents, forbearance agreements, settlement agreements) ALWAYS make sure that it includes "Waiver of Defense and Claims" clause.
  - Bars any claims / defenses to be brought up prior to date of contract. If borrower will not sign, then assume they want to keep a reason to sue later. Thus, the exclusion of the clause is a non-starter

Modifications / Restructures cont.

- Given reduction in operations, relief warranted to right-size operations and preserve liquidity.
- In normalized circumstances, modifications / forbearances granted based on reasonable financial pro formas & business plans (being sure not to be subsidizing principal's lifestyle, other creditors, etc).
  - Management's ability to operate through a crisis is important consideration in underwriting.
    - Are they reducing expenses to match revenue, preserving liquidity, limiting distributions (not eroding capital base), negotiating with other creditors / trade? Are they transparent and reasonable? Are they forecasting / planning with realistic assumptions?
  - Reasonable consideration needs to be obtained that will eventually allow for upgrade and / or payoff upon completion of plan.
- For operating companies, the bank may want to build into their workout agreement that the borrower engage a **turnaround consultant** or Chief Restructuring Officer (reasonably approved by the bank)

Legal Issues

Utilize competent counsel and judiciously utilize their billable hours to minimize cost to Bank

Business decisions (Bank) versus legal decisions (Lawyer)

Keep ALL correspondence between Bank and Borrower as well as any other third parties (accountants / brokers etc).

Follow up conversations with email / letter recapping discussion (especially when adversarial in nature)

Limit discussions between opposing counsel UNLESS Bank counsel is present.

Litigation

Sometimes litigation is unavoidable based on intractability of Borrower or incorrigibility of Bank (approval committee) or a combination thereof.

Try to minimize fees, to conduct as much due diligence up front, and to understand Borrowers ultimate strategy

Provide counsel with thorough history and the Bank's ultimate goal.

- Limitation of costs
- Foreclosure of asset
- Money judgment against guarantor

Goal should be to get to Summary Judgment ASAP

Ensure proper procedure followed prior to commencing litigation

- Showed good faith in addressing issues (correspondence) in settling outside of litigation.
- Properly defaulted and allowed cure of default.
- Formally demanded the loan in accordance of documents.
- Review Complaint prior to filing and provide counsel all necessary documents
- (Note, Mortgage, Guarantees, Security Agreement, Merger Certification – if originating lender is different entity, etc)

Litigation cont.

Be absolutely certain that Bank wants to foreclose asset or replevin collateral prior to commencing.

For example: Be reasonably sure no environmental issues or other hindrances to liquidating collateral

Litigate on payment defaults (maturity / missing or partial payments, potentially missing taxes, or foreclosing priming liens) and rarely on pure technical defaults (covenants, missing financials, etc)

After commencing litigation, stay open to settling matter outside of obtaining judgment; however, any deal must be predicated on its finality

Stipulated settlement allowing borrower time to short sell collateral with monthly payments and consent to judgment if deal defaults or matures

Litigation Strategies

Consider use of mediation as way to avoid continued litigation

In case of IRE, consider first use of sequestration of rents prior to trying to obtain a receiver on property as the former has a lower threshold to prove while the latter the Bank has to prove “waste”. Plus, receivers are expensive and can create more cost then benefits

File all necessary Orders concurrently with lawsuit – Access Orders, Motion for Rents / Show Cause

Bankruptcy

- Usually filed on eve of MSJ hearing or foreclosure auction –STAYS ALL COLLECTION ACTIONS
  - Chapter 11 – Reorganization of debtor
    - Sub-Chapter V allowing Small Business Reorganization (streamlined reorganization, several benefits to debtor)
  - Chapter 7 – Liquidation of debtor
- Determine if BK filed to legitimately reorganize or to further delay final adjudication or collection efforts
  - If filed in bad faith or if two-party dispute, consider moving to dismiss BK outright
- BK not necessarily bad thing, as full disclosure required under explicit threat of federal prosecution if fraud / perjury is committed.
- Power of BK Court lies in its ability to break contracts

Bankruptcy cont.

- If Chapter 11, focus / review Statement of Financial Affairs (SOFA) determine what Class of creditor you belong, and if you are a Secured, Under-Secured, or Unsecured creditor as of date of petition (filing)
- If Secured, determine if you are entitled to adequate protection payments as well as post-petition interest & fees
- If Under-secured determine if "Relief from Stay" is best course to obtain optimal resolution relative to negotiate / fight confirmation
- If Unsecured, be cognizant of legal costs relative to benefits that can be reasonably obtained by being adverse to confirmation (*Is the juice worth the squeeze?)*
- If a BK 11, the debtor will need to file Plan of Confirmation and Disclosure Statement
  - Essentially a new business plan for reorganized debtor
- Reengineer the pro forma projections in the Plan and thoroughly test all relevant assumptions (sources of revenues, variable costs, proposed debt service to creditors etc)
- Utilize their plan to reconfigure based on market assumptions to test feasibility.

Bankruptcy cont.

- Every situation is unique in BK, but generalities remain:
  - BK is EXPENSIVE. Balance cost of legal, expert testimony, and fees versus benefits that can be reasonably assumed to be obtained.
  - BK is a court of equity. BK judges tend to give debtors benefit of doubt and if an operating company that has employees (non-insiders), it will seek to confirm a plan over the legitimate objections of creditors*
    - Feasibility arguments relative to the Plan are tough and expensive to prove and judges will take debtor's assumptions at face value*(my opinion)
- Negotiate hard and protect your rights, but all things being equal, execute a deal that gets something rather than fight Confirmation for nothing. (Pigs get fat, hogs get slaughtered)
  - The marginal return that can be reasonably gained via fighting a confirmation to get risk appropriate pricing or restructuring is not worth the expense that will be outlaid to achieve
  - However, be sure terms provided would be commensurate with what the debtor would be able to reasonably get in the market place (assuming a performing non-BK borrower)
- If you execute a deal, insist for strong default remedies i.e. immediate foreclosure or conversation of BK to Chapter 7 liquidation if debtor fails to abide by the plan

Summary

RAISE YOUR HAND IF ANY EARLY WARNING SIGNS NOTICED OR YOU NOTICE NEW BEHAVIORAL PATTERNS.

BE PREPARED TO HAVE TOUGH CONVERSATIONS AND ASK CRITICAL QUESTIONS. BE SURE TO TAKE GOOD NOTES AND RECORD MINUTES.

TRUST BUT VERIFY!

OVERRIDING GOAL IS TO REHABILITATE / RESOLVE RELATIONSHIP AS QUICKLY AS POSSIBLE. AIM FOR A WIN / WIN.

LIMIT ONGOING LIABILITY AND MINIMIZE RISK.

CASH IS KING!

Workout 201: Case Studies in Distressed Debt & Resolutions

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S.N.A.F.U. Framework

- S: Situation
- N: Needs Assessment
- A: Analysis (financial and NPV)
- F: Fix
- U: Utility (upgrade or resolution for the bank)

Dealership Nightmare

$4.4MM term loan; 10-year term; 30-year am, four years into deal. Rate fixed via SWAP that is underwater by $280M. Franchise motorcycle dealership, secured by two properties – two dealership locations on primary frontage of major highways in metro.

20-year relationship, primary owner / sole guarantor died two years ago. Business taken over by daughter and substituted guarantor after death. Recession occurring, no financial statements received over 2 years and no analysis of DSCR covenant.

Line met with borrower to discuss business. She provided past due financial statements. Showed declining operations, violations of DSCR covenants, and most critically shared that the businesses were closed and franchise rights sold

Dealership Nightmare cont.

S: Multiple defaults under loan documentation. Exit relationship. Borrower wanted to provide keys to bank. Taxes, insurance, and maintenance deferred. Payment default pending. Course of dealing with failure to monitor prior to meeting.

N: Updated appraisal, environmental, property inspection, title update, brokerage contract. Appraisal showed property valued at $4.5MM (104% LTV), Phase I & II were mostly clean (property use); title showed no liens. No broker engaged and PFS showed limited assets. Franchise sale docs rejected as under an "NDA". Property inspection showed part of collateral was pet cemetery.

A: Given pet cem and negotiating position; action plan on stipulated foreclosure with borrower brining cash to cover costs & shortfall to value, and retaining pet cem parcel and attaching easement to improved property. Ran NPV considering foreclosure, note sale, and work through (borrower sale).

F: Negotiated settlement, closed deal, credit bid asset and transferred to ORE. Applied $325k in cash to close out loan on system.

U: Deal resolved when ORE sold both parcels for $3.8MM in 14 months. 10 months after close of settlement, media called regarding the pet cem, but bank didn't own.

Fractured Mobile Home Co-Op

18MM mobile park co-op term loan at 20 year / 30 year am also fixed with a 10-year SWAP. Originated right before GFC as the conversion of 55 and up for rent MHP on barrier island in Florida. Crash had left property fractured at about 45 / 55 "owners" and for rent units. The for-rent units were about 95% occupied but all had fixed term leases (for life leases) which were substantially under market. Also given age of most of the MH at park, they couldn't be moved.

Loan was a non-profit loan to the home-owners group and the deal was done non-recourse. Given great recession and lack of liquidity reserves, property was downgraded and sent to workout. The LOB ordered an appraisal which showed that the property was only worth $4MM (almost a $20MM decline in value) and LTV of 450% LTV. Despite payment performance, given lack of liquidity less than 6 months of DS, loan moved to NPA and loan charged down to 90% of appraised value.

Fractured Mobile Home Co-Op

S: Massively overleveraged property with no recourse. Default under liquidity and DSCR covenants. Large write-down.

N: Engage specialized outside counsel that was expert in FL Co-Op statutes. Order totally new appraisal given input from the expert attorney. Obtain interim financials, budget and reserve study / analysis.

A: Credibly challenge appraisal, which happened to be wrong (excluded $650M in NOI and new / different report provided a value of $15MM). However, given under 1x DSCR and lack of replacement reserves and RTA and "write-up" not feasible. Borrower BoD changed and considering special assessments to get back into compliance. Ran NPV for a work through and Note Sale.

F: Bank sitting on large recovery position and not a strategic relationship. Found community bank lender that wanted to increase book and would purchase note. Much higher value than investors. Takeout bank even agreed to reduce loan amount to margined balance (giving each Co-op owner about $25k in "equity".) This incentivized members to terminate SWAP as community bank didn't have trading desk.

U: "Sold" loan to community bank at approx. 70% PAR, but recovered $9.5MM in gains.

Too Much Spice Is Not Nice

$7MM relationship to food / spice-mix manufacturer comprised of a $4MM LOC, and two OOCRE RE term loans secured by two separate industrial facilities. One was a warehouse and the other was their manufacturing plant / HQ. $4MM was originally unmonitored while the OOCRE was held by two different SAE. LOC was UCC-1 and the term loans were appraised at approx. 85% LTV

Borrower lost their biggest customer, a major big box retailer, and the owner had taken out large distributions over the previous 3 years. REV dropped by 35% and EBITDA by 40%. Cash flow was below 1x and current ratio was 1x and D/TNW spiked to 5x. Guarantor showed limited unprotected assets.

Upcoming maturity of the LOC and inability to cash flow resulted in transfer to workout

Too Much Spice Is Not Nice

S: Customer needed to reset business and replenish capital into the business. Customer acknowledged problem and was amenable to injecting capital into the business

N: Business plan to return to prior revenue targets, pick up efficiencies for improved margins. More importantly, company was overleveraged and needed to inject capital. Especially since the RE appraisals did not reflect increased value (in fact declined from origination).

A: Given a "retain" designation, NPV of Workout was clearly superior.

F: Contingent on customer injecting $1MM into business, the bank restructured LOC to a borrowing base and allowed 85% of A/R and 40% of inventory (subject to normal exclusions). Crossed-up all facilities, required more frequent reporting. Leverage and cash flow convents instituted with Q reporting. Field exams required bi-annually.

U: Company returned to financial health and at a subsequent renewal event requested increase to line to facilitate further growth. Bank provided renewal terms but declined increase due to proforma that showed funds would repay guarantor for prior injection.

Glut of Goods

$15MM consumer goods manufacturer with two factories and strong receivable base to credit customers (big box stores). However, products were generic with no trademark. Comprised of $10MM borrowing base and two OOCRE facilities at 80% LTV.

Coming out of COVID, customer bought assets (inventory) of competitor and requested bank finance. Increase in BB and provided new $1MM LOC to facilitate purchase. Despite increase in exposure, bank waived field exams and audit requirements.

For FYE22, borrower had not sold inventory, spiking DOH turns. Further, consolidation with customer base had started to trip concentration exclusions, reducing viability. Worse still, inflation and increase in fixed costs had eviscerated margins.

LOB believed that the best solution was to refer to ABL division. However, ABL provided generalized terms and ordered exam. However, given personnel changes ABL didn't provide final terms for over 120 days. LOB extended, however, at last minute rather than providing the increase, ABL required a $2MM pay down. Borrower rejected and threatened claims.

Glut of Goods

S: Borrower overleveraged with operational loss on internal statements that was strongly believed to be greater when audit was provided and inventory written down.

N: Lender liability claim needed to be quashed and loan extended. Loan was moved to Substandard given losses, overleverage, and tight liquidity. Consultant needed to help management develop plan to reorganize their business.

A: Projections were believed to be too optimistic and didn't solve leverage problem. NPV was not conducted given primary focus was to resolve aforementioned claim and maturity issues.

F: Provided 6-month renewal with cross-collateralization of facilities (documented w/ waiver language) via forbearance (due to failure to provide audit default). Signaled that future renewal predicated on bi-annual field exams, increase in rate spread, and likely capital injection. Encouraged to seek alternative financing.

U: Borrower refi'd via private credit fund, which provided longer term and higher advance rate and concentration ratios. Concurrent with refi, the customer was able to sell excess inventory overseas at a discount.

Recovering Non-Profit

$25MM industrial revenue bond deal issued by municipality and secured by FREM on large medical treatment / office building. The facility provides addiction treatment therapy and detox center with approx. 175 beds. The relationship also has a $5MM RLOC, $1MM line secured by equipment / vans / buses and $500M P-Card.

Firm is well-known extremely well-known Non-profit in a large city. Only covenant on the loans is a DSCR requiring 1.05x coverage. Starting in 2018, NFP began to experience cash flow issues with several overdrafts. Relationship transferred as a retain due to cash flow issues in interim statements and lack of liquid reserves. Over the course of 8 payroll periods, the borrower had the bank tap its sinking bond fund to process payroll.

Primary issue was inability to efficiently collect government receivables (increased from 30 days to 75), which was the primary revenue driver. The RLOC didn't revolve and the P-Card was maxed out. At next audit, the borrower was in violation of the DSCR.

Recovering Non-Profit

S: Large reputational risk given the business of NFP (opiate treatments during the opiate crisis). Limited cash reserves besides bond sinking fund. Management did not seem to be fiscally astute and was only focused on mission.

N: Needed to obtain updated appraisal, go forward budget, and reorganization plan to improve margins. Operationally, processes needed to be overhauled so that government receivables could be collected timely.

A: Borrower's cash flow budget and re-org plan did appear to be bring the company back into compliance and build liquidity. Limited alternatives given bonds (refi / discount etc) would not be feasible.

F: Provided 6 mo deferral on interest on LOCs and crossed up all facilities (some equity in CRE even though special use). Part of agreement would require quarterly liquidity covenant (with free cash) in addition to DSCR.

U: Borrower reduced head-count, sold non productive assets, and replaced CFO. After deferral, borrower was in compliance with covenants. However, founding CEO retired and then COVID hit, delaying upgrade for 12 months. Eventually returned to line.

Workout 301: A Survey of Alternative Collection Strategies

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Agenda

- Pre-Workout / Forbearance
- Private Credit
- Net Present Value
- Note Sales
- Turnaround Consultants
- Receivers / CRO's
- Litigation
- Article 9 Sales
- Replevin / Auctions
- Bankruptcy
- Assignments for Benefit of Creditors (ABC)

Core Decision Framework

- Is the business viable?
- Is management credible?
- Is time your friend or enemy?
- Which option maximizes Net Present Value?

Pre-Workout and Forbearances

Pre-workout actions are designed to stabilize the situation, preserve value, and protect the Bank's position before formal enforcement begins.

- **Temporary agreement to delay enforcement of remedies**
- Used to:
  - Allow time for diagnosis and planning
  - Clean up documentation or security and collateral issues
  - Avoid premature or unnecessary litigation
  - Obtain Waiver of Claims / Defenses
  - Ensure all interested borrower parties have personal guarantees and look for additional collateral

Key Pre-Workout Items

- Obtain current, complete, and reliable financial information. Engage new appraisal or field audits to verify value of collateral as well as any inspections and Phase I or II.
- Assess management credibility and transparency
- Determine whether the issue is **liquidity, operational, or structural**
- Execute a Pre-Negotiation Agreement (if necessary)

PRIVATE CREDIT: STRATEGIC ROLE & WHEN IT MAKES SENSE

Private credit refers to non-bank direct lending provided by alternative lenders outside the regulated banking system.

Core Characteristics

- Funded by private capital (credit funds, PE-backed lenders, specialty finance)
- More flexible structures than traditional bank loans
- Higher pricing reflects higher risk tolerance and speed
- Relationship-driven and transaction-specific

Strategic Role in the Credit Ecosystem

- Complements — not replaces — traditional bank lending
- Serves borrowers that fall outside bank credit boxes
- Provides bespoke solutions where regulatory constraints limit banks
- Acts as a bridge between distress and stabilization
- May also serve as a means for a borrower to grow their way out of current distress

Bank Perspective

- Banks often coexist, partner with, or refer to private credit
- Private credit can absorb risk banks cannot hold
- Enables banks to manage exposure and retain other portions of the lending relationship

PRIVATE CREDIT: WHEN IT MAKES SENSE

Private credit is most strategic when the business has value, especially on the balance sheet or intrinsically in the collateral.

Good Use Cases

- **Good balance sheet / bad operations**
  - Temporary operational dislocation
  - Need for turnaround time and flexibility
- **Good business / capital structure problem**
  - Over-levered but viable enterprise
  - Near-term maturity or liquidity crunch
- **Speed and certainty required**
  - Imminent maturity, acquisition, or refinancing deadline
  - Bank process too slow or restrictive
- **Non-conforming credit profile**
  - Covenant pressure, short history, or transitional cash flow

Why Private Credit Works Here

- Flexible covenants and repayment structures
- Willingness to underwrite complexity and execution risk
- Ability to price risk rather than avoid it
- Often a bridge back to traditional bank financing once stabilized
- May facilitate growth opportunity as part of turnaround plan

Banker Takeaway

- Private credit is a **tool**, not a failure of banking
- The right capital at the right time can preserve enterprise value
- Discipline is knowing *when to step aside and when to partner*
- Can be part of a long term borrower retention strategy as they stabilize and the bank can offer more cost effective working capital

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Net Present Value Analysis

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Net Present Value Analysis

- Run NPV comparing different feasible scenarios and reasonable / conservative assumptions
  - Foreclosure litigation / Stipulated foreclosure / Deed-In-Lieu
  - Discounted Payoff / Short Sale
  - Note Sale (always at discount relative to legal balance if not collateral value)
  - Various work-through scenarios
    - Modification (can vary widely based on repayment terms – accelerated amortization / duration)
    - A/B/C Note Restructure (if going to right size based on CF/collateral and forgive portion of debt – cognizant of accounting categorization)

NPV Analysis -- Assumptions

- Loan Balance: $1,500M / $1,264M (legal / book)
- Graded Non-Accrual (payment default)
- Collateral of a $2MM shopping center (appraisal)
- Property has NOI of $10Mk/ mo

  - Settlement Scenario (Deed-In-Lieu)
    - Stipulated foreclosure. Obtain net rents after settlement. 12 months to sell
  - Foreclosure (Adversarial)
    - Adversarial Foreclosure pay past due taxes. Guarantor judgment / payoff of $200k at end of litigation
  - Note Sale
    - Sell note in quick one-off sale at 87% of PAR
  - Restructure / Workout
    - Restructure at 8%/25am which is B/E DSCR at NOI. All carrying costs and legal / appraisal paid by customer.
  - Alternative (A/B Note Restructure)
    - A/B Note Restructure with A note rightsized at 1.25x DSCR at 8%/25 yr am new note balance of $1,187k. B note of $313k accrues interest at 13% interest due at maturity.

SUMMARY NPV ALTERNATIVES ANALYSIS (000's omitted)

Date: 12/31/2023
Relationship Name: ABC Borrower
Prepared by: J. Alpert
Obligor(s): 123456789 Obligor #'s: 18

Input Parameters

Current Status Summary			Global Assumptions		
Unpaid Principal Balance		$1,500	Collateral Category		Commercial
Net Book Balance of Loan		$1,264	Collateral Type		Shopping Centers
Risk Rating:	75		Analysis Start Date (e.g. 6/30/2010)		12/31/2023
Accrual Status		Non-Accrual	Analysis End Date (e.g. 5/31/2015)		12/31/2027
			Discount Rate (based on Shopping Centers, Non-Accrual)		17.0%
			Overhead Factor (per $ of loan/per annum)		1.50%
			Estimated Settlement ($ / Date)	$0	8/31/2024
			Estimated Time to Complete Foreclosure (in months)	12	12/31/2024
			Estimated Marketing Time (in months)	18	6/30/2026
Appraised Value		$2,000	Net Property Disposition Proceeds (from ORE)		$1,700
Appraisal Date		9/30/2023	Property Appreciation/Depreciation Expectation (per annum)		-1.0%
OPV/Current Value		$2,000	Estimated Note Sale Net Proceeds		$1,300
OPV/Current Value Date		9/30/2023	Estimated Marketing Time of Note(s) (in months)	2	2/29/2024

Cash Flow Analysis Results

Scenario Summary	Settlement (and transfer to ORE)	Foreclosure	Note Sale	Workthrough	Alternate
Total Inflows	$1,830	$2,070	$1,300	$1,757	$2,042
Total Outflows	$125	$260	$5	$40	$2
Net Cash Flow	$1,706	$1,810	$1,295	$1,717	$2,040
Estimated Final Resolution Date	Dec 2025	Jun 2026	Feb 2024	Dec 2025	Dec 2027
NPV (Expected Case)	$1,218	$1,166	$1,245	$1,270	$1,167

CASH FLOW COMPARISON

Analysis Start Date: 12/31/2023 Discount Rate: 17.0%

Analysis End Date: 12/31/2027

	Q4 2023	Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025	Q1 2026	Q2 2026	Q3 2026	Q4 2026	Q1 2027	Q2 2027	Q3 2027	Q4 2027	Total
Quarter Ending	12/31/2023	3/31/2024	6/30/2024	9/30/2024	12/31/2024	3/31/2025	6/30/2025	9/30/2025	12/31/2025	3/31/2026	6/30/2026	9/30/2026	12/31/2026	3/31/2027	6/30/2027	9/30/2027	12/31/2027	
SETTLEMENT CASH FLOWS (000's omitted)																		
Total Inflows	-	-	10	30	30	30	30	-	1,700	-	-	-	-	-	-	-	-	1,830
Total Outflows	72	20	5	5	5	5	5	5	5	-	-	-	-	-	-	-	-	125
Net Cash Flow	(72)	(20)	5	25	25	25	25	(5)	1,695	-	-	-	-	-	-	-	-	1,706
PV of Cash Flows (Settlement)	(71)	(19)	5	22	22	21	20	(4)	1,222	-	-	-	-	-	-	-	-	**1,218**
FORECLOSURE CASH FLOWS (000's omitted)																		
Total Inflows	-	-	-	-	50	30	30	30	30	-	1,700	-	200	-	-	-	-	2,070
Total Outflows	105	14	14	14	14	14	14	14	14	14	14	9	9	-	-	-	-	260
Net Cash Flow	(105)	(14)	(14)	(14)	36	16	16	16	16	(14)	1,686	(9)	191	-	-	-	-	1,810
PV of Cash Flows (Foreclosure)	(103)	(13)	(13)	(12)	30	13	13	12	12	(10)	1,124	(6)	118	-	-	-	-	**1,166**
NOTE SALE CASH FLOWS (000's omitted)																		
Total Inflows	-	1,300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1,300
Total Outflows	2	3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5
Net Cash Flow	(2)	1,297	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1,295
PV of Cash Flows (Note Sale)	(2)	1,247	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	**1,245**
WORKTHROUGH CASH FLOWS (000's omitted)																		
Total Inflows	12	35	35	35	35	35	35	35	1,500	-	-	-	-	-	-	-	-	1,757
Total Outflows	2	5	5	5	5	5	5	5	5	-	-	-	-	-	-	-	-	40
Net Cash Flow	10	30	30	30	30	30	30	30	1,495	-	-	-	-	-	-	-	-	1,717
PV of Cash Flows (Workthrough)	10	29	28	27	26	25	24	23	1,078	-	-	-	-	-	-	-	-	**1,270**
ALTERNATE SCENARIO CASH FLOWS (000's omitted)																		
Total Inflows	9	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	1,619	2,042
Total Outflows	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2
Net Cash Flow	8	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	1,619	2,040
PV of Cash Flows (A/B/C)	8	27	26	25	24	23	22	21	20	19	19	18	17	17	16	15	863	**1,167**

CAPITAL RELIEF OR BALANCE SHEET CLEANUP

TIME CONSTRAINTS

LIMITED INTERNAL WORKOUT RESOURCES

NOTE SALES: OVERVIEW & STRATEGIC RATIONALE

A note sale is the sale of the bank's legal interest in a loan to a third party as a permanent exit strategy.

- **Why Banks Use Note Sales**
  - Immediate monetization of a distressed asset
  - Transfers litigation, enforcement, and execution risk
  - Eliminates ongoing servicing, legal, and carrying costs
  - Provides certainty and speed of resolution
- **When Note Sales Make Sense**
  - Loan is no longer a desired or strategic relationship
  - Problems with repayment sources or collateral
  - Bankruptcy, litigation, or irreconcilable management issues
  - Desire to exit an industry, asset type, or geography
  - Exiting certain relationships can provide liquidity to allow more time and patience on other portions of a distressed portfolio
- **Key Banker Reality**
  - Note sales are often executed at a discount to face value
  - Discount reflects time value, risk, and cost avoided
  - Lower gross recovery can still produce higher NPV

NOTE SALES: PROCESS, RISKS & NPV LENS

Key Execution Considerations

- Confirm complete and accurate loan documentation
- Validate collateral (appraisals, environmental, title, UCC)
- Identify and disclose known defaults, litigation, or claims
- Prepare a concise loan summary with key terms and background

Buyer Selection & Diligence

- Pre-qualify buyers for capital strength and ability to close
- Conduct background and reputational checks
- Understand buyer strategy (yield play vs. control of collateral)
- Use confidentiality agreements and controlled data rooms

Risk Management & Governance

- Avoid sharing internal credit memos or privileged materials
- Manage internal price expectations early
- Ensure clean exit with no ongoing liability or tail risk
- Communicate internally and prepare borrower notification at closing

PORTFOLIO SALES: BULK RISK MANAGEMENT TOOL

A portfolio sale involves pooling multiple loans and selling them in a single transaction to reduce exposure and free capital.

Why Banks Use Portfolio Sales

- Reduce concentration or sector exposure (e.g., CRE)
- Dispose of non-strategic or criticized assets efficiently
- Generate immediate liquidity and capital relief
- Achieve better pricing and execution than selling loans individually

Key Portfolio Sale Principles

- Loans are selected based on risk, strategy, and exit criteria
- Pooling similar assets attracts more buyers and competitive bidding
- Risk-adjusted NPV should be evaluated at both the loan and portfolio level
- Third-party loan sale advisors help with valuation, process, and buyer access

Banker Discipline

- Strong documentation and disclosure are critical
- Set cutoff dates for modifications or changes
- Continue servicing loans normally until closing
- Portfolio sales are a strategic pruning tool — not a fire sale
- Ensure internal checks are in place so that the "left hand and the right hand" are aware which loans are being sold and of any constraints

TURNAROUND CONSULTANTS: WHEN & WHY

When to Consider a Turnaround Consultant

- Repeated covenant breaches or deteriorating performance
- Declining or volatile cash flow visibility
- Borrower slipping from *stress* into *distress*
- Sudden disruption (market correction, lost customer, failed acquisition, regulatory or cost shock)

Why Early Engagement Matters

- Preserves optionality before a crisis limits choices
- Improves transparency and credibility with lenders
- Protects enterprise value and collateral
- Courts and stakeholders view proactive stabilization favorably

TURNAROUND CONSULTANTS: ROLE & BANKER CONSIDERATIONS

What Turnaround Consultants Actually Do

- Develop **13-week cash flow forecasts** and liquidity controls
- Improve operational discipline and cost structure
- Identify inefficiencies, waste, and capital needs
- Act as an objective intermediary among stakeholders
- In more serious situations, may step into leadership roles (e.g., CRO)

Banker Role & Risk Management

- Consultants are engaged by the **borrower**, not the bank
- Bank can require, but must allow borrower select (bank can give 3-5 names)
- Proper timing and fit reduce lender liability risk
- Often cost-effective when measured against value preservation
- Can make workout officer more efficient through improved communication and delivery of requested information (less chasing of borrowers for financials, etc.)

Receiverships & Chief Restructuring Officers (CROs)

Receivers

Court-appointed fiduciary

Appointed in context of litigation

Preserves and monetizes assets

Limits borrowers' ability to use cash from business to fight the bank

CRO / Interim Executives

Management overlay or replacement

Direct operational authority

Often lender-driven in distressed situations

Litigation

Litigation is a tool, not a strategy

Costly, slow, and uncertain

Creates discovery and lender liability risk

Remember, the Bank drives strategic objective not the outside attorney

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Litigation

Sometimes litigation is unavoidable based on intractability of Borrower or incorrigibility of Bank (approval committee) or a combination thereof.

Try to minimize fees, to conduct as much due diligence up front, and to understand Borrowers ultimate strategy

Provide counsel with thorough history and the Bank's ultimate goal.

Limitation of costs
Foreclosure of asset
Money judgment against guarantor

Goal should be to get to Summary Judgment ASAP

Ensure proper procedure followed prior to commencing litigation

- Showed good faith in addressing issues (correspondence) in settling outside of litigation.
- Properly defaulted and allowed cure of default.
- Formally demanded the loan in accordance of documents.
- Review Complaint prior to filing and provide counsel all necessary documents
- You do not want to discover a documentation/collateral deficiency after you have filed
- (Note, Mortgage, Guarantees, Security Agreement, Merger Certification – if originating lender is different entity, etc)

Litigation cont.

Be absolutely certain that Bank wants to foreclose asset or replevin collateral prior to commencing.

- For example: Be reasonably sure no environmental issues or other hindrances to liquidating collateral
- If the collateral is NOT real estate, does the bank have a plan to deal with the storage costs and logistics of acting on that collateral

Litigate on payment defaults (maturity / missing or partial payments, potentially missing taxes, or foreclosing priming liens) and rarely on pure technical defaults (covenants, missing financials, etc)

After commencing litigation, stay open to settling matter outside of obtaining judgment; however, any deal must be predicated on its finality

- Stipulated settlement allowing borrower time to short sell collateral with monthly payments and consent to judgment if deal defaults or matures

Litigation Strategies

Consider use of mediation as way to avoid continued litigation

In case of IRE, consider first use of sequestration of rents prior to trying to obtain a receiver on property as the former has a lower threshold to prove while the latter the Bank has to prove “waste”. Plus, receivers are expensive and can create more cost then benefits. If the borrower is not receiving cash from the collateral, their ability to fight the bank is usually greatly diminished

File all necessary Orders concurrently with lawsuit – Access Orders, Motion for Rents / Show Cause. This is a big part of having a strategic vision to use litigation as a tool as a means to an end.

Replevin & Auctioneers

Replevin to recover specific personal property

Auctioneers provide valuation and disposition

Process and documentation are critical

Article 9 Sales

UCC FORECLOSURE ON PERSONAL PROPERTY

PUBLIC OR PRIVATE SALE

COMMERCIAL REASONABLENESS IS KEY RISK

Bankruptcy

- Usually filed on eve of MSJ hearing or foreclosure auction –STAYS ALL COLLECTION ACTIONS
  - Chapter 11 – Reorganization of debtor
    - Sub-Chapter V allowing Small Business Reorganization (streamlined reorganization, several benefits to debtor)
  - Chapter 7 – Liquidation of debtor
- Determine if BK filed to legitimately reorganize or to further delay final adjudication or collection efforts
  - If filed in bad faith or if two-party dispute, consider moving to dismiss BK outright
- BK not necessarily bad thing, as full disclosure required under explicit threat of federal prosecution if fraud / perjury is committed.
- Power of BK Court lies in its ability to break contracts
- Talk with outside counsel and be aware of risks in a bankruptcy and potential treatment of your claims

Bankruptcy cont.

- If Chapter 11, focus / review Statement of Financial Affairs (SOFA) determine what Class of creditor you belong, and if you are a Secured, Under-Secured, or Unsecured creditor as of date of petition (filing)
- If Secured, determine if you are entitled to adequate protection payments as well as post-petition interest & fees
- If Under-secured determine if "Relief from Stay" is best course to obtain optimal resolution relative to negotiate / fight confirmation
- If Unsecured, be cognizant of legal costs relative to benefits that can be reasonably obtained by being adverse to confirmation (*Is the juice worth the squeeze?)*
- If a BK 11, the debtor will need to file Plan of Confirmation and Disclosure Statement
  - Essentially a new business plan for reorganized debtor
- Reengineer the pro forma projections in the Plan and thoroughly test all relevant assumptions (sources of revenues, variable costs, proposed debt service to creditors etc)
- Utilize their plan to reconfigure based on market assumptions to test feasibility.
- A section 363 sale of assets through the bankruptcy allows for a sale free and clear of other claims and may be a way to scrub assets of junior interests and allow repayment of secured claims

Bankruptcy cont.

- Every situation is unique in BK, but generalities remain:
  - BK is EXPENSIVE. Balance cost of legal, expert testimony, and fees versus benefits that can be reasonably assumed to be obtained.
  - BK is a court of equity. BK judges tend to give debtors benefit of doubt and if an operating company that has employees (non-insiders), it will seek to confirm a plan over the legitimate objections of creditors*
    - Feasibility arguments relative to the Plan are tough and expensive to prove and judges will take debtor's assumptions at face value*(my opinion)
- Negotiate hard and protect your rights, but all things being equal, execute a deal that gets something rather than fight Confirmation for nothing. (Pigs get fat, hogs get slaughtered)
  - The marginal return that can be reasonably gained via fighting a confirmation to get risk appropriate pricing or restructuring is not worth the expense that will be outlaid to achieve
  - However, be sure terms provided would be commensurate with what the debtor would be able to reasonably get in the market place (assuming a performing non-BK borrower)
- If you execute a deal, insist for strong default remedies i.e. immediate foreclosure or conversation of BK to Chapter 7 liquidation if debtor fails to abide by the plan

Assignment for the Benefit of Creditors (ABC)

- ABC's are a creation of state law and very from one state to the next
- Think of them as a state level bankruptcy, but without the ability to modify contracts
- They are often cheaper and faster than a bankruptcy, but are not the right fit for all insolvency situations
- Because things are not as public, they may be a solution when speed and discretion are important for a going concern.
- They are a poor fit if there are complex claims and disputes that need to be adjudicated.
- They will not address personal liabilities.

PRIVATE EQUITY SOLUTIONS: WHY THEY WORK

Private equity capital can unlock value when a business is viable but requires a change in strategy, operations, or control to succeed.

What Private Equity Capital Provides

- Permanent capital, not incremental liquidity
- Ability to **change control and reset strategy**
- Operational expertise and active ownership
- Alignment between capital structure and enterprise value

When PE Is Most Effective

- Business has **sustainable enterprise value**
- Problems are **operational, strategic, or managerial**
- Existing ownership or governance constrains execution
- Additional debt alone will not fix the problem

Outcome
➡️ **Equity capital stabilizes the business and preserves going-concern value**

CAPITAL INJECTION VS. OWNERSHIP RESET

The key question is not "can the borrower be saved," but whether enterprise value supports new equity capital.

Good Business / Bad Balance Sheet

If Enterprise Value Is Sufficient

- Business can support recapitalization
- Equity capital injected to:
  - De-lever the balance sheet
  - Fund turnaround or repositioning
  - Support new management and strategy
- **Result**
  ➡️ **Capital injection + control = value preservation**

If Enterprise Value Is Insufficient

- Debt exceeds realistic enterprise value
- Existing equity is impaired or out of the money
- Capital injection alone will not solve the problem
- **Result**
  ➡️ **Ownership must change to preserve residual value**

EXECUTING THE OWNERSHIP TRANSFER

When value exists but capital structure does not, private equity ownership is often achieved through credit-driven solutions.

Common Paths to PE Ownership

- Note sale to a control buyer
- Debt-for-equity conversion
- Article 9 foreclosure
- Section 363 sale (in BK)
- Discounted Payoff

Why This Works

- Aligns ownership with risk and capital invested
- Removes legacy constraints
- Preserves jobs, operations, and customer relationships
- Maximizes enterprise value rather than liquidating assets

Banker Takeaway

- Equity capital saves businesses **when value exists**
- Ownership transfer saves value **when capital structures fail**
- Private equity provides a disciplined solution across both outcomes
- Could be best outcome if banks collateral could further dissipate in an insolvency proceeding

Key Takeaways

- Earlier action preserves options
- Speed often improves NPV
- Doing nothing is still a decision
- There is an expense associated with giving a borrower more time. Ensure the banks gets value in exchange.
- CASH IS KING!!!

Section II: Published Articles

Early Warning Signs & Borrower Behavior

Identifying trouble before it becomes a loss

Don’t let the Sins of Your Client be Deadly to Your Bank
By JASON ALPERT, CTP, CRC
The RMA Journal, February 2017

IT’S OFTEN SAID that the best bankers are created in times of economic hardship, and indeed the lenders forged out of the Great Recession learned critical lessons in credit underwriting that resonate today.

Some of these lessons, such as underwriting quantifiable variables like collateral and cash flow, can be easily incorporated into a bank’s policies. But the more qualitative factors of lending are difficult to identify and mitigate against. This is especially true of the character component of credit underwriting. Aside from prohibiting lending based on criminal record, credit history, or business type, incorporating and disseminating underwriting standards based on the borrower’s character is almost impossible to do. However, the customers whose problem loans reach the desks of a bank’s workout department do have common characteristics.

Excluding situations in which macroeconomic, regulatory, or industry changes had an undue influence on the business, the majority of distressed loans are caused by the actions of the borrower. This is especially true for small businesses in which an individual controls the company. Understanding that the company is an extension of its owner’s personality, the vigilant lender can be on the lookout for the common personality traits that often result in borrower defaults—referred to here as the Seven Deadly Sins of Small Businesses.

Christian tradition recognizes Seven Deadly Sins: lust, gluttony, sloth, wrath, envy, pride, and greed. In the biblical sense, they are the categories of sin considered catastrophic to the soul. In the commercial sense, they are the practices that lead to sustained losses, credit de- fault, and even bankruptcy. All pulpits aside, the behaviors identified with each sin are a collection of mortal and venial transgressions that form a common thread among many distressed businesses.

As in the case of the soul, these sins corrupt the business over time, and their effects become exponentially greater as they go unchecked. As a trusted advisor to clients, a banker can provide commercial salvation by identifying and delicately addressing these vices before they sink an enterprise into the abyss.

More importantly, recognizing these sins can also serve as a red flag to a lender during the origination or monitoring of a credit. Regardless of where in the credit cycle the lender is, when a small business engages in any of the Seven Deadly Sins, it is walking a fine line between paradise and perdition. The prudent lender always takes appropriate action to mitigate these character risks.

Lust

Lust, the first sin listed in traditional dog- ma, appears to be the least applicable to the cold climate of capitalism. Small business owners, however, understand how alluring their enterprises and operations can be. In the fog of lust, loving what you do and how you do it can quickly become a reckless infatuation.

The hallmark of lust is the borrower's irrational refusal, even in the face of overwhelming evidence, to diversify or mitigate concentrations in the business model. When trusted advisors and objective third parties attempt to convince the owner that the love affair has become a fatal attraction, willful blindness takes over. The result is that the owner denies the problem or, even if recognizing it, refuses to take proactive measures to spread the concentration risk.

Even as the business spirals down into a whirlpool of negative earnings, the owner views his or her position as that of the noble captain going down with the ship. All the while, the owner attempts ill-suited measures to save it, essentially bailing water without patching the gaping hole in the bow. During underwriting, the prudent banker recognizes the concentration risks inherent in a prospect's business model, product mix, or clientele and takes efforts to limit exposure where appropriate.

Gluttony

It is a compliment in the entrepreneur world to be considered "hungry." Hunger powers the drive to excel and succeed. But it can also push business owners to reach too far too fast. Like Icarus, small business owners aiming for the sky may find the wax wings that helped them get off the ground can melt as they soar closer to the sun.

For the small business owner, hunger resides in market share and revenue growth. Having had a taste of it, successful owners may develop an insatiable appetite. The more they get, the more they crave. Acquiring more requires expansion. And expansion, when sought irresponsibly, is generally pursued with an unrealistic view of the company's potential, leading to overcapacity. That overcapacity is purchased by overleveraging. And it is nearly always accomplished with financing that leads owners to use as much debt as they can get approval for.

When responsible lenders refuse to provide funding, gluttonous owners seek alternative sources of capital—usually with expensive financiers who have fewer restrictions, looser covenants, and less credit concerns. When those resources are tapped, the owner attempts to finance the expansion internally by stretching trade payables and creditors or even by cannibalizing other productive resources.

The naïve overconfidence of the gluttonous owner fuels belief that the power of the company will always result in revenues that can be generated and collected. When the projected steady rise into the black fails to materialize, owners are left dangling precariously from a fiscal cliff. Having overleveraged beyond the company's capacity to service debt or by abusing trade credit to the point that inputs must be paid for with cash, owners quickly find that there are no more lifelines aside from expensive equity injections or bankruptcy.

A more sinister form of gluttony is reflected in some business owners' psycho- logical incapacity to repay their debts. This hoarding mentality is highlighted in the old real estate developer's adage, "A dollar borrowed is a dollar earned, and a dollar repaid is a dollar lost." While individuals who practice this perverse form of business are few and far between, more latent examples of this type of gluttony can be found in im- proper use of credit facilities. For instance, the business owner may attempt to use an operating line of credit—which should be used to support the seasonal, short-term working capital needs of a business—to purchase long-term fixed assets.

An astute banker mitigates the allure of gluttony by understanding the client's capital structure and ensuring it is appropriate for the industry. Only then can the banker provide proper credit facilities that match the borrowing cause, asset class, and ultimate repayment source.

Sloth

The idea of sloth appears antithetical to the entrepreneurial class. After all, these are people who had the gumption and drive to start, manage, and fund their own businesses. Even within this segment, though, there is a tendency for them to ignore the less "fun" parts of the business. This sin is pervasive and also extends to dealing with mundane ancillary problems, such as engaging in repairs or maintenance, that arise during the normal course of business. Seeking to avoid situations that cause psychological stress or create conflict, owners instead leave them untreated, which only allows the problem to fester. This deferral of duty causes operational inefficiencies and increases costs. What was once a mi- nor scratch becomes a wound requiring amputation.

By ignoring issues, not only do owners create a larger problem, but they lose control of the ability to find or participate in a solution. Keeping one's head in the proverbial sand could result in a business's counterparties taking actions that, once commenced, cannot be unwound. An example would be a banker attempting to restructure a defaulted real estate loan and the borrower ignoring such overtures. When the borrower fails to respond, the bank ultimately sells its note to a buyer who forecloses on the property, leaving the borrower with no options besides bankruptcy.

To avoid encountering slothful borrowers, bankers should engage in time- honored lending practices such as conducting annual property inspections and maintaining continual contact with their clients. Through these simple activities, lenders can obtain a wealth of information. They may uncover examples of deferred maintenance, for example, or a disorganized, inefficient shop. Moreover, by staying in touch, the banker conditions borrowers to keep the bank engaged through the highs and lows of their individual business cycles.

Wrath

Wrath, or vengeful anger, is the opposite of the cool composure most business owners must possess in order to survive, let alone thrive. All businesses have lean or difficult periods that correspond to their various business cycles. Often, wrath does not manifest itself until extremely difficult or trying circumstances arise.

Successful business owners navigate and lead their organizations through these troubled times, while weak owners regress into bitterness and fail to adapt. Frustration leads to poor decision making that only exacerbates the problems. Moreover, anger and resentment over bad situations or economic conditions are then projected by the owner on to other parties that are not responsible for the issues at hand.

A classic example is the business owner who blames the bank for “allowing” the owner to overleverage a business. Another instance of wrathful indignation would be a contentious partnership dispute, where two partners operate in a mature industry and one partner leaves the business in order to set up a competing shop. Spite may lead one partner to divert and focus resources on ruining the other’s operations. Time, effort, and money better invested in retaining customers and maintaining supplier relationships are wasted in challenging, harassing, and threatening the ex-partner’s business.

Another manifestation of wrath is a “win at all costs” attitude that usually leads to mutually assured destruction. Some owners will go so far as to sabotage their own businesses or spitefully file for bankruptcy with no feasible reorganization plan in order to bilk creditors and claim a pyrrhic victory over them. Through these bad-faith actions, wrath leads owners not only to lose control of an immediate situation, but also to burn the reputational bridges that an owner will desperately need in order to start over. In these instances, irrational anger destroys relationships and leads to an impasse in negotiations.

When wrath leads people to cross the metaphorical Rubicon, they lose control of the situation and the eventual out- come. The prudent lender will research public records and credit references to verify that a client has never engaged in this behavior.

Envy

The latent sin of envy is an external deception of perception, leading the business owner to make misguided decisions or investments. Envious individuals, relying on hearsay and unreliable sources, are always seeking a deal similar to that which their competitors, friends, and neighbors supposedly received.

In the banking world, envy often manifests itself as a strategic default by a debtor, made in the hope of obtaining better loan terms or even debt forgiveness. This risky gamble can work at times in the debtor’s favor (if aided and abetted by a debtor-friendly banker); however, implementing such a strategy without assessing the potential downside risk can be a fatal mistake for the company. Once the default is declared by the bank, the company can find itself subject to costly penalties, fees, and even litigation. Envy can also lead business owners astray, convincing them to make dangerous, unethical, and potentially criminal decisions, all in the name of gaining a perceived competitive advantage. For instance, envious owners may do something as benign as squeezing a competitor’s employee for information—or something more sinister, such as corporate espionage or outright theft of intellectual property. And while imitation is the sincerest form of flattery, when management compromises its principles to obtain the proprietary information of its competitors, the dry rot of the ethical foundation begins to spread.

Beyond the potential litigation and criminal issues that may arise from envious decisions, the evaporation of ethics creates cracks in the foundation on which the company is built, dooming the structure to eventual collapse. Bankers can avoid conducting business with envious borrowers by truly knowing their clients and their value proposition to the marketplace. Reviewing their customers' mission statement and operational his- tory should give bankers insights into how their clients conduct business and generate value to their customers.

Pride

If envy is the "external deception of perception" then pride is its inverse: an internal deception of perception that is essentially an overvaluation of the individual's or company's worth. Lack of humility, exemplified by dismissing competitors as not being a threat, rejecting compromises, and squandering opportunities over petty issues, often leads to negative results. The Darwinist marketplace will eventually eliminate those companies that are oblivious to the various forces having a material impact on their operations.

A common manifestation of pride would be the business owner who refuses to develop and establish worthy employ- ees as successors to bolster the organization and eventually become CEO. This failure to build an organic management team and implement a succession plan can have serious repercussions.

First, lenders and other business partners are often hesitant to conduct business with a company in which the key man is so integral to the firm that it will virtually cease to exist in the event of his death, disability, or other life-changing event.

Second, once the owner is ready to re- tire, the failure to implement a succession plan, including a way to fund the plan without overleveraging the company, can result in devolution of the business and undue destruction of value. This is especially true when the owner, close to retirement, attempts to sell the business, and an outside buyer for the company cannot be found. The prideful owner is left to cede the reins of the business to an underprepared and overwhelmed management team and must hope that the business is profitable going forward in order to fund his retirement.

Astute lenders will address succession plans with their customers and require key-man insurance as a condition to their loan documents if the CEO is deemed so vital to the operation that the departure of this individual would imperil repayment of the loan.

Greed

Greed is the last of the Seven Deadly Sins and a favorite of many in the business world. However, greed for the purpose of this discussion is not the insatiable appetite for material wealth or the blind pursuit of the almighty dollar. Greed, in its simplest and most basic form, is the misallocation of risk relative to return. When this type of greed manifests itself under certain conditions, it results in enormous losses.

Like an individual predisposed to a gambling addiction greed becomes a problem when the calculus balancing the risk/reward equation is continually bro- ken or simply ignored. Greedy behavior can appear in various forms, such as all-in "bet the farm" ventures, refusal to diversify, and speculative investments made without proper due diligence. And when the prudent businessperson succumbs to greedy behavior, it is ultimately a failure to think strategically and to mitigate un- warranted risks.

For small business owners, greed is most commonly exhibited as the reckless push for high sales growth without considering how that growth is going to be financed (either with debt or equity). Paradoxically, high sales growth is one of the greatest risks facing small businesses because it can quickly result in insolvency.

Consider a company whose only goal is to grow revenue and whose owners are able to contribute only a fixed level of equity. The company has no problem selling its products. But in order to achieve its sales goals, it provides financing to any and all customers, regardless of the customer's creditworthiness. And while suppliers can provide credit to the company, eventually the cash resources of the company begin to dry up as the company cannot collect its receivables on a timely basis, if at all, and in turn has trouble covering its costs.

Eventually, the owner's initial equity contribution is spent and further outside debt financing is required. But because the overriding goal is to increase sales at all costs, even the cash contributions from lenders are exhausted and the company must begin squeezing suppliers and employees to preserve cash.

Finally, when all of the manipulations of working capital have been used, the company simply does not have enough cash on hand to pay its bills, and it is forced to seek bankruptcy protection. Prudent bankers understand the inherent risks of reckless growth and have candid conversations with their clients about responsible revenue expansion. Additionally, these bankers protect their institutions by implementing financial covenants that monitor growth, such as minimum levels of tangible net worth, borrowing limits, and working-capital- to-sales ratios, which provide an early warning to the lender that the client is engaging in greedy practices.

Conclusion

All business owners are prone to the Seven Deadly Sins because they are natural hu- man tendencies. It is the prudent lender who can identify these tendencies and either decline the deal or structure the credit appropriately to mitigate the risk.

Like a doctor performing periodic medical screenings to ensure proper health, lenders should conduct intermit- tent evaluations of their borrowers' minds (ownership and management), bodies (business fundamentals and financials), and spirits (organizational mission) to ensure that all three are working in unity and without the corrupting influence of the Seven Deadly Sins. For if one of the three is compromised or missing, the rest of the entity could wither and die. While the road to recovery can be painful and expensive, the health, safety, and profitability of an organization can be saved. However, like a patient going through recovery and rehabilitation, only the company's ownership can truly implement the cure (and lenders, of course, cannot interject themselves owing to potential lender liability claims).

If the past is prologue and all transgressions are forgiven, then the sinner can be redeemed. And through that redemption, owners may realize not only the stabilization of their businesses, but also an outright improvement in operations, cash flow, and enterprise value.

Non-Profits Behaving Badly

By JASON ALPERT, CTP, CRC

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IN AN INCREASINGLY competitive and highly regulated environment, banks must behave as responsible corporate citizens. With regulators, the media, and clients focused on how banks conduct business, it is imperative that institutions demonstrate the ability to work with the stakeholders in their communities.

Almost all banks invest significant time and money to publicly demonstrate their commitment to community, whether through highly publicized grants, sponsorships, or organized volunteering by bank personnel. However, the most fundamental commitment a bank can make to its community is to lend to organizations that serve a greater purpose than just making a profit.

By lending to religious institutions, schools, trade associations, and civic organizations, banks receive both the visibility and inherent marketing advantages of being a preferred vendor to a large and captive customer base. Additionally, nonprofit loans are lucrative, often fulfill several goals in the bank's mission statement, and serve various community re- investment initiatives.

Of course, as with all credit products, lending officers must properly under- write and structure deals to limit the bank's downside risk. This is especially true with nonprofits, given that banks have limited options for working out or resolving a nonprofit loan. The same fac- tors that made the loan so attractive to the bank in the first place—high visibility with an ingrained and active customer base—also limit the bank's ability to re- solve the loan in the most economically beneficial way.

Given the high profile of such deals and the significant reputation risk at stake, resolution strategies such as litigation and note sales are immediately off the table except in cases of fraud or insolvency. Usually, the bank must see the deal through term, often making concessions that it otherwise wouldn't.

With that in mind, the bank must take extra care during origination, due diligence, and monitoring. Once the money has been lent or even been committed to be lent (through a commitment letter or matching funds agreement), the bank is tied to the organization until the loan is fully paid.

As with all niche lending, nonprofits involve nuances and differences that must be considered. Beyond normal credit analysis of the client's operating budgets, giving units, or specific project fund-raising, red flags can be raised during underwriting. While these red flags are not proof of a nonprofit's inability to perform under their loan documents, they do represent latent risks and deviation from typical nonprofit governance and performance.

When nonprofits demonstrate atypical performance and adopt high-risk behaviors, their conduct can be compared to that of “bad boy” rock stars, prima donna celebrities, and pampered athletes. Diva leadership, extravagant expenditures, poor selection of business partners, large entourages and staff, and inability to manage money are all indicators of a poorly operating nonprofit.

By being mindful of these parallels, lenders can avoid enabling their borrowers into self-destruction and insolvency. It's important for lenders to take note of these bad behaviors before nonprofits do damage to the bank's balance sheet and, to borrow a term from the aforementioned rock world, become a “deadhead” asset.

The Cult of Personality

All nonprofits are established with a mission. Churches, schools, and charities are often founded by transformative individuals who have a clear strategic vision for the organization. Such leaders frequently inspire tremendous devotion from their congregation and administrative staff.

While this loyalty is certainly an asset, especially as it pertains to religious organizations, since it results in more giving units and higher tithing overreliance on one individual carries risks that must be identified and mitigated by the lender.

First, the transformative leader who establishes a nonprofit often has an outsized influence on the organization's direction and performance. When a popular pastor who established a church and grew the congregation eventually retires, the result could be a precipitous decline in membership. Banks that have lent to churches when they were at peak attendance can easily find themselves overleveraged once popular pastors leave and take the cash flow with them.

As when lending to a small business dependent on a key person, the prudent lender would be wise to ensure an organization has a defined succession plan in the event of a pastor's exit. Failure to recognize that loan repayment is tied to a particular pastor can result in sudden default. Bankers should be sure they are lending based on the underlying eco- nomic demographics of the institution and not solely on a pastor's ability to generate attendance.

Second, some transformative leaders act as if the nonprofit exists to serve their purposes and not necessarily the stated aims of the organization. These self-dealing individuals treat the non-profit as a closely held business and use its resources to meet their own personal needs and wants. For instance, they may reward themselves with large salaries, purchase homes and cars for personal use, and engage in nepotism by hiring family and friends to administrative positions.

To the extent there is a governing board, the self-serving leader sets the agenda, controls debate, and overrides votes if necessary. To mitigate this risk, banks should lend only to organizations that have formalized board and governance documents and also a healthy, diverse, and arm's-length relationship between the board and founding leader. Only then will the best interests of the organization be ensured—rather than those of the founding leader.

Investment in Nonproductive or Obsolete Assets

By definition, nonprofits are supposed to be motivated to accomplish the aims of their mission and not necessarily churn a recurring profit stream. To that end, many nonprofits and religious organizations invest in hard assets that help instill values and inspire their constituencies to accomplish their vision. This is especially true for religious groups that need an awe-inspiring facility to provide members the sanctuary to feel closer to their higher power.

Additionally, for civic organizations and schools, a beautiful facility can increase enrollment and maintain relevance for scarce resources such as donations and membership dues. However, like the celebrity who purchases a mansion and adds extravagant touches that ultimately decrease marketability, a nonprofit can develop a facility that serves a limited purpose far beyond the aims of the organization. While there is a natural functional obsolescence inherent with non- profit facilities—they are not designed to generate revenue efficiently—it is the lender's responsibility to ensure they do not over-advance on the collateral.

Functional obsolescence, or the loss of property value derived from super adequacy, inefficient design, or unattractive style, can manifest itself in various forms, some of which are not readily apparent to most bankers. For instance, when financing the construction of a nonprofit building that will be a headquarters or a school, the bank should be wary of high-end finishes that do not conform to industry standards or seem inappropriate for the intended use. Examples would be marble floors and granite countertops in middle-school restrooms. While some impressive finishes are to be expected in religious buildings, such as stained-glass windows and marble altars, the buildouts of the various nonpublic areas should match the practical use of the space.

A lender should be aware of the functional obsolesce inherent in collateral, either by identifying items in the construction budget that equate to these items or by reducing the amount it is willing to lend against the estimated amount of the functional obsolesce provided in an appraisal. This is especially important when lending against a special-use property such as a church or a school, where the lack of alternative uses limits the market- ability of the asset in a liquidation. Banks can easily find themselves beyond their supportive equity cushion if they fund specialized or luxury finishes with debt, as those items do not generally translate into higher value in a distressed sale.

Moreover, nonprofits sometimes have difficulty disassociating between wants and needs in the capital budget. Set on projecting a robust operation to their constituency, some nonprofits purchase assets that provide little marginal return relative to the stated need. For example, a school may purchase extra buses that are not needed or replace existing buses well before the end of their useful life.

When purchased through specific fund-raising efforts, these items pose little risk to the bank, assuming the board had no other need for the cash. However, when these nonessential items are lever- aged, they become an extra burden on the organization and represent idle assets on the balance sheet. Overall, bankers can help clients identify which items in the capital budget add value to the organization and which are superfluous and wanted only for vanity's sake.

Hidden Profit Motive

Many nonprofits are founded and governed by volunteers who generously donate their time and energies. Such individuals are the lifeblood of the nonprofit, and their efforts make the organization a pillar in their communities.

However, like a naïve rock band being taken advantage of by an unscrupulous record executive, there are companies— often with a for-profit motive—that at- tempt to leech off the host organization. These companies often assume the guise of helpers by offering to provide a service that is beyond the capabilities of the volunteer board.

For smaller organizations that do not competitively bid, that “help” could mean paying above-market rates for extraneous services that strain their budgets. Lenders would be wise to question budget line- items that seem beyond the norm for similar services and have frank discussions regarding the bidding process required in the governing documents. The bank can engender a tremendous amount of goodwill by offering this advice to the board, especially when it results in savings to the organization.

The more insidious form of the hidden profit motive occurs when the founding principal or leader establishes a non- profit and concurrently launches a for- profit management company to provide it with “essential services.” The management fees paid by the nonprofit, often without the board or other stakeholders understanding the relationship with the for-profit, can be steep and result in bud- gets that leave little room to accomplish the nonprofit’s mission.

This type of non-arm’s-length situation is often seen in the charter school industry, where the school is a nonprofit but all the business functions (staffing, payroll, accounting, etc.) are conducted by a for-profit management company. (Full disclosure: This writer sits on the board of a nonprofit charter school that terminated its contract with the founding for-profit managing company.)

While this relationship is not inherently inappropriate, it can lend itself to large conflicts-of-interest issues—as well as abuse. Bankers need to understand the true nature of the relationship between a nonprofit and its essential service providers, especially when those contracts represent the largest portion of the bud- get. When significant conflicts of interest exist, they could portend other ethical challenges in the organization that the bank may wish to avoid.

Bloated Budgets

All nonprofits seek to provide the maxi- mum benefit to the populations they serve. But although well intended, their goals could put enormous budgetary constraints on the nonprofit as the size of the staff grows beyond the organization’s resources. Like the large paid entourages that are a hallmark of athletes and celebrities, enormous resources can be drained from an organization quickly when the hiring and spending decisions are not balanced against the organization’s needs and budget.

Management’s desire to add jobs and justify large budgets can even subvert the mission of the nonprofit, resulting in negative publicity that turns away donations. Recent news reports have exposed charitable organizations that use the majority of donations to support the management and fund-raising staff, resulting in only pennies on the dollar for the cause they claim to represent.

Once a nonprofit realizes the unsustain- ability of a large administrative apparatus, painful staffing cuts have to be undertaken, demoralizing the organization and potentially damaging its ability to bring in enough revenue to support fixed costs, including debt. Accordingly, it is important that loan officers fully review their clients’ operating budgets and financials to ensure that the level of administrative costs, especially payroll, is reasonable given the organization's revenue and mission. If the organization is primarily a fund-raising one, the bank should recognize the truth of the business model and mitigate the risks appropriately.

Living on the Edge

Living paycheck to paycheck is not the exclusive domain of high-profile insolvent athletes. Nonprofits can be dependent on one or two revenue sources concentrated in a few lump-sum disbursements (for example, a government grant). Cash management and the ability to adhere strictly to budget plans are critical for the nonprofits that rely on only a few cash inflows per year. Obviously, the bank must keep a close eye on these borrowers, given the concentration risk and lack of readily available repayment sources.

Despite the apparent ability of these revenue sources to recur over time, it only takes the failure of one grant renewal application, a change in government policy, or the loss of a large donor for the non- profit to find itself in the bank's workout department. Accordingly, the bank should conduct stress tests of the nonprofit's ability to lose a portion of its revenue and still be able to cover fixed costs.

In addition, even in situations where nonprofits have multiple and robust sources of revenue, they sometimes overspend on the effectuation of their mission and do not hold enough in reserve for capital improvements. For borrowers with real-estate term loans, the bank should insist that their collateral be reserved and that cash be set aside to cover major repairs.

For instance, a well-secured church with stable giving units and revenue— but no replacement reserves set aside— may be required to leverage the building further or run an emergency capital campaign to fund unexpected repairs. While it is best practice for a religious organization to either have a continual capital campaign or set aside a portion of its budget toward replacement reserves (as outlined in an appraisal or reserve study), the bank should require that rea- sonable reserves be held at the bank as part of the loan agreement.

Conclusion

Banks can act as responsible corporate citizens and increase their civic profile by lending to the invaluable nonprofit organizations in their communities. A responsible lender will not let nonprofit clients engage in unnecessarily risky behavior that threatens the repayment of the loan and the nonprofit's prospects going forward.

Sometimes tough conversations need to happen. Quitting bad habits—such as operating beyond budgeted means or entering into unfavorable for-profit management contracts is never easy. However, with the support, encouragement, and possible requirements of their lender, nonprofits can return to doing what they do best: serving the community.

Early Warning Signs: Harbingers of loan distress and default
By JASON ALPERT, CTP, CRC
The RMA Journal, September 2022

IN TODAY'S POST-COVID economic world, bankers have the unenviable task of trying to grow and maintain their book of business in a highly volatile and uncertain environment. Bankers are bombarded by contradictory data such as low unemployment and high inflation, or high reported revenue growth offset by compressing margins and supply chain issues, all of which are compounded by the ongoing pandemic, recession fears, and geopolitical risks. In this era of increased uncertainty and volatility, bankers and credit officers must remain vigilant to maintain the credit quality of their portfolio.

Of course, not all borrowers are forthcoming in sharing bad news with their banker due to fear, ignorance, or arrogance, leaving lenders to determine the true nature of the loan through their own powers of observation. Fortunately, bankers don't need to look into the future a la Nostradamus to mitigate loan distress and default risk. By being aware of early warning signs, they can get ahead of loan performance problems by recognizing deviations in a borrower's behavioral patterns or business operations.

The Three Types of Early Warning Signs

Early warning signs can generally be categorized into three main types—contractual, financial, and relational—with nuances associated with the different types of changes in behavior and operations. Regardless of the type of early warning sign(s), once the banker takes notice, it is imperative to elevate the situation, document the issue, and implement an action plan. Additionally, the banker needs to address the situation professionally with the borrower, which will allow the borrower the opportunity to explain and provide more information or proffer potential resolutions. However, sometimes the conversation (or lack thereof) is confirmation that the loan is distressed and needs to be managed by the workout department.

Contractual Early Warning Signs

The most obvious early warning sign of a distressed borrower is a contractual breach of the loan documents, typically represented by late or missed loan payments; consistent overdrafts; and failure to pay taxes, insurance, or maintenance expenses on collateral. These items are mandatory obligations of the borrower, and only a desperate or struggling one would dare to violate them given the serious repercussions that could be incurred. Failing to make loan payments or pay mandatory taxes and insurance premiums is symptomatic of a borrower experiencing severe cash flow or liquidity issues. These contractual costs should be some of the highest priority spending, given that default could put the enterprise and property at risk. Most

Jurisdictions would consider missed loan payments a sufficient basis to start foreclosure proceedings, while missed tax payments can prompt a super priority line ahead of a bank mortgage. Inability to pay insurance premiums also puts the property at risk in the event of a claim. If a borrower has missed these crucial payments, it is critical that the bank follow through to determine the root cause. If necessary, the bank may need to pay the taxes via protective advance or force place insurance to protect the collateral.

Likewise, consistent overdrafts from a customer's checking account are indictive of a borrower experiencing cash f low issues and not managing its cash needs. Bankers should be very cautious about approving overdrafts, as they are tantamount to a short-term, unsecured loan to the borrower (especially since most overdrafts cannot accrue interest or earn enough fees to justify the true risk). Even if the overdrafts are rejected by the bank (negating the risk of holding the "unsecured loan"), consistent overdrafts can put other obligations at risk if the borrower suffers reputational and transactional impacts regarding its suppliers or work force that imperil the firm's general operations.

Finally, a company's failure to spend on necessary maintenance such as upkeep of real estate, periodic equipment servicing, or even funding required replacement reserve accounts are also red flags. Most loan documents require the borrower to maintain the collateral in good condition and not allow its "waste." However, monitoring collateral preservation is not easy and requires an especially vigilant or inquisitive banker. The best proxy to determine if the customer is maintaining collateral is to conduct old-fashioned property inspections. These will detect any ap parent deferred maintenance, or if the property looks "old and tired." Additionally, the bank may request equipment-servicing invoices of collateral to verify if the customer is conducting routine maintenance. Finally, a common form of monitoring is comparing maintenance expenses year over year as reported in the financial statements. A large decrease in that spending category should warrant a question—one that hopefully sheds light on a reasonable business justification that is not indicative of a potential operating problem.

Financial Early Warning Signs

The second category of early warning signs relates to the financial information and comparative analysis conducted by banks when they receive financial reporting from the borrower. When underwriting and structuring a loan, banks include financial reporting requirements and covenants specifically to monitor and assess the risk of the asset during the life of the loan. During the bank's periodic review process of the company, the analysis derived from the financial statements includes a wealth of information that indicates the health of the company. Similar to other early warning signs, negative reports or information contained in the financials need to be explored with the borrower and documented in the bank's system for review and consideration. The most basic early warning sign that can be gleaned from the financial statements is a report of declining trends or deteriorating operational performance. For instance, a banker noticing that revenue or EBITDA decreased year over year would obviously ask the borrower about what was driving the change and how the situation will be remedied. In today's environment, bankers may no tice compressing margins due to supply chain issues or increased costs due to high inflation. While these issues are being experienced by many companies across numerous industries, it is imperative that the bank understands the borrower's plan to adjust to the rapidly changing conditions, assesses feasibility, and determines if the plan impairs or improves the bank's loan position.

On the balance sheet side, early warning signs manifest in the form of rapidly declining liquidity, stretch and expansion of trade credit, and current asset/liability growth—in other words, extension of the cash conversion cycle beyond historical norms for the company or industry. First and foremost, a rapid depletion of a firm's liquidity is obviously a cause for concern and should be discussed immediately with the customer (even if there is not a liquidity covenant in the loan documents). The borrower may be drawing down cash to cover losses from deteriorating operations or to fund an unforeseen expense, capital improvement, or unannounced expansion or asset purchase. In any event, the customer will need to explain how it will replenish liquidity to adequate levels. The situation may warrant the development of a cash budget showing cash burn.

Additionally, a large, unexpected increase in accounts payable warrants discussion with the borrower. It could indicate cash flow issues and a reliance on stretching trade to fund the short falls. Accounts payable as a liability is a type of leverage that the borrower should treat carefully. Failure to adhere to the terms or repay promptly may result in suppliers cutting off the company or requiring cash on delivery. These actions, in turn, may trigger the customer to scramble to source other, more expensive or lower-quality suppliers, or resort to more expensive means of financing for payables.

Finally, current asset and liability growth as represented by an extension of a company's cash conversion cycle may indicate operating problems within the company and demand more pressure on the company's capital base. Slower account receivable collections, longer inventory hold periods, and/or the aforementioned stretch of trade may lengthen the company's cash con version cycle. Each component should be analyzed in the context of the company's historical norms as well as that of industry peers. Significant variations should be explored with the firm to determine if it is a short-term issue or a longer-term problem. For example, slower accounts receivable turns may be due to recessionary pressures felt by the company's customers or a change in the accounting department that is making the company less efficient in its collections. Likewise, longer inventory hold periods may imply the company's products are obsolete or no longer in demand, requiring it to lower prices to move inventory—which could impact cash flow and profitability. In any event, significant deviations or outliers need to be explored with the company. Its management should have a plan to resolve and eliminate the inefficacies over the long term.

The last subcategory of financial early warning signs includes the most severe: financial covenant violations, over-advances on borrowing base, and stale/fully drawn revolving lines. While it is true that a financial covenant violation or over-advance on a borrowing base are both already technical defaults, they are also the strongest indicators of a company's distress absent a hard-money payment default. A financial covenant violation represents a serious adverse change in the borrower's financial capacity from the initial underwriting of the loan and needs to be addressed immediately by the bank and the custom er. Banks get themselves into trouble when servicing loans if they uncover a financial covenant default but then take no action or continually waive the violation if it occurs over several testing periods. Habitually waiving the default or ignoring the violation entirely can put the bank in jeopardy by establishing a “course of dealing” issue with the borrower; in short, the bank’s actions may speak louder than the words of its loan documents. A borrower may claim a “course of dealing” defense when the bank seeks to enforce the default at a later date, as the borrower has relied on the bank’s lackadaisical enforcement of that condition previously. The best way to deal with a financial covenant default is to work with the borrower and bank management to determine if the loan terms and covenant should be revised based on the borrower’s current reported financial condition. To cure the default, both parties need to return to the table and negotiate an appropriate alternative, as the initial covenant was bargained when the loan was structured and priced, and should be re-examined given the changed risk profile. If the bank determines that the default is an isolated occurrence and, for relationship preservation reasons, determines not to enforce it, the bank should nevertheless issue a “Reservation of Rights” letter, acknowledging the default and preserving its rights to enforce in the future.

Over-advances on borrowing base components and failure of an unmonitored line of credit to properly revolve are both examples of a line of credit not being used appropriately. The former indicates that a bank is undercollateralized with its outstanding loan. This latter represents the outstanding loan’s conversion from operating to permanent working capital (which is repaid from profits—not conversion of current assets to cash). In either event, the bank needs to engage the borrower to fix the credit facility, especially in the case of an over-advanced borrowing base where the bank must get the borrower to remedy the collateral gap immediately either by re-margining the loan or by obtaining additional collateral.

Relational Early Warning Signs

Relational early warning signs can be detected in how a borrower interacts with the bank or a negative shift of the relationship profile. They include of lack of communication, failure of borrower to meet deliverable deadlines, notice of liens or lawsuits involving the borrower, and what can be represented as the “Five D’s” of Distress: death, disability, drugs, divorce, and disagreements.

A change in the communication pattern with a customer is a common relational early warning sign because it is human nature to avoid difficult conversations or delay the disclosure of information that may result in adverse actions against the business. However, this early warning sign should be taken with a grain of salt, as there could be variety of reasons why the level of communication has changed. A more serious relational red flag is when a borrower begins to miss informational deadlines, especially when required under the loan documents. Failure to provide financials when due or various certifications should be treated seriously. They are technical defaults and, if necessary, appropriate violation letters should be sent to put the borrower on notice as soon as possible. While there may be perfectly reasonable explanations for the tardiness of the documents, the failure at best represents some level of disorganization by the borrower. At worst, it represents obfuscation and potential fraud on the part of the borrower by withholding critical information from the bank.

Another relational early warning sign is when the borrower becomes embroiled in legal matters, such as having liens filed against collateral, or is being sued for a material reason that is not readily covered by insurance (such as a slip and fall or car accident). The former can be indicative of cash flow issues or inability to resolve debt, which affects the bank's collateral, while the latter represents a serious situation for the borrower that could drain its time, resources, and focus—and ultimately result in a large judgment liability. When informed of a lien, the bank should obtain a title update on its collateral to verify the scope of the problem and work with the borrower to determine how it plans to clear the title. If the lienor is about to take adverse action or the borrower cannot resolve, the bank should send the asset to the workout department for resolution. If the bank is made aware that the borrower is named in significant litigation, the bank should obtain as much detail as possible about the nature of the suit. In the event the litigation is an existential threat to the company, for example, a substantial monetary judgment or the loss of key intellectual property are possible—the bank should elevate to the internal legal and credit teams to determine if the company has a going concern problem. Less-threatening litigation should be analyzed in the context of the litigation's potential drain on the resources and focus of the firm and its owners, and if they are willing and able to fund any judgment or settlements.

That leaves the final relational early warning signs to be discussed: the Five D's of Distress. Death, disability, drugs, divorce, and disagreements are highly impactful and damaging changes to the people who are critical in a borrower's operations. If these extremely stressful events are observed in a borrower's key personnel, the matter should be escalated to bank management—and the potential impact on loan repayment should be quantified. A quick summary of the potential impacts of each of the Five D's follows:

Death: Obviously the most impactful. If a bank is notified of the death of a borrower's s primary principal, it should be prepared to consider how to tactfully approach this issue—which is usually a default under the personal guaranty. Hopefully, the bank has previously discussed the firm's succession plans and/or has required key person insurance for the company. The bank will also need to weigh whether it wants to file a claim on the estate or find a substitute guarantor if the deceased's assets do not flow to another party to the loan.

Disability: Similar to death but relates to when a principal is incapacitated due to disease or accident. Strong succession planning or key person insurance is the usual mitigant. If either are not in place and bank has concerns with the firm's replacement management, it should consider sending the loan to workout.

Drugs: Alcoholism and addictions are serious diseases. If the bank observes that the key person is often intoxicated or has been arrested related to their addiction (drug arrest or DUI), it should evaluate if the

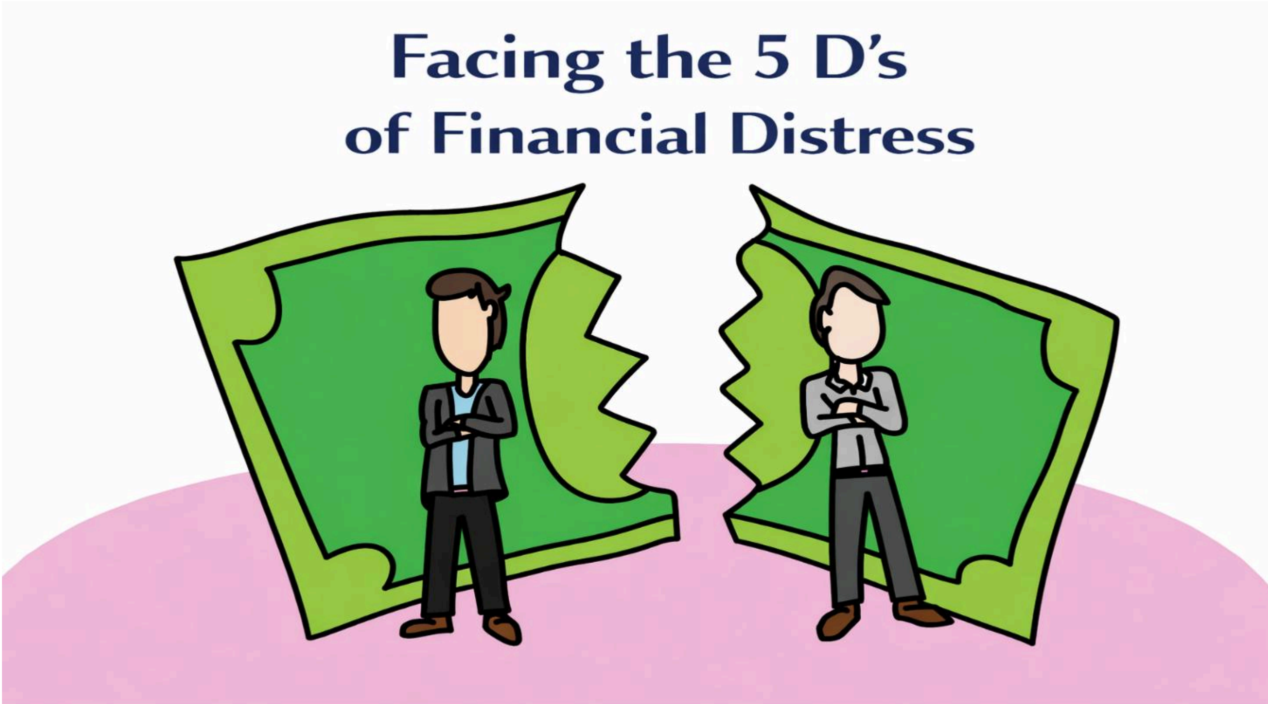
person can functionally lead the company. Impaired individuals often do not make good decisions and can be inattentive or even self-destructive in the throes of their addiction.

Divorce: The dissolution of a marriage can be devastating to an individual, throwing their personal life into disarray. Aside from the personal impact, difficult divorce and custody hearings can be a major cost and disturbance to the person leading the business, distracting them from efficiently operating the company. Additionally, for many small business owners, their primary asset is the company. When they have to settle the divorce, they may end up ceding ownership to the ex-spouse and/or leveraging the company to pay for the alimony and settlement. Both can be defaults under the loan documents (especially if the ex-spouse was never a party to the loan) and change the borrowing profile.

Disagreements: This D refers to partnership disputes that spill into open hostilities in the leadership of a firm. These damaging power struggles not only expend the time focus, and resources of a firm but can divide staff and the stakeholders of the company. Besides imperiling the potential repayment of a loan, the bank must stay at arm's length in the dispute and avoid getting in the middle of any internal business dispute due to the potential lender liability issues that could result.

Conclusion

Bankers are constantly inundated with information and are often challenged to make the best decisions in a dynamic, competitive, and disruptive environment. Knowing the customer and being perceptive to changes and deviations from the norm are critical in identifying and acting on early warning signs. As Ben Franklin stated, "An ounce of prevention is worth a pound of cure." Being inquisitive and proactive when alerted to these red flags can limit the damage and loss incurred by the bank through early treatment of the potential problem. Conversely, ignoring or dismissing early warning signs can allow the problems experienced by the borrower to fester, limiting the bank's ability to help borrowers resolve the issues. Even if the message and the medicine are not what the customer wants to receive, it is always best for the bank to address problems timely to avoid potential credit impairment



The Workout Window: Facing the Five D's of Financial Distress
By JASON ALPERT, CTP, CRC
The RMA Journal, June 2024

QUESTION: Jason, I have a relationship with a manufacturer that is owned by two brothers. They've recently had a falling out and are now suing each other to gain control of the business. I expect the bank is going to get drawn into this fight and will have to produce documents and testimony. How should we handle this sensitive situation?

JASON: I would get your legal partners involved as well as consider sending this to your workout department for monitoring. This disagreement is a major red flag and this fight will probably result in lower performance for the business: Ownership is distracted and the rancor could trickle down the organization and up through supply chain. Meanwhile, the litigation will eat up the resources of both brothers personally, who I assume are guarantors on the deal. Having a workout team monitor this deal is appropriate, given the probability of legal involvement. It is critical that the bank establish that it is 100% neutral in this disagreement and will not take sides. Additionally, deliver the message that the bank expects full compliance with its loan documents regardless of any legal outcome. This is especially true for any material change in ownership that may result—for example, one brother buying out the other or being awarded the ownership interests of the other, which would require a renegotiation of the documents / loan terms to account for the new ownership structure. Always remember the 5 D's of Distress: Death, Disability, Drugs, Divorce, and Disagreements!

Constrained by Course of Dealing Concern

QUESTION: I am a recent hire at my new bank and one of the loans in my portfolio has a debt service coverage ratio (DSCR) covenant that has been internally waived every year since COVID began. Management is getting frustrated about the borrower's failure to improve operations and continuing covenant violations. Management has directed me to enact the default interest rate at the next opportunity. But I believe the customer will be very upset with me and our relationship will start on a negative basis. How should I approach this?

JASON: Well, declaring default on day one is never a good way to start a relationship. But you will have an even bigger problem if you issue a default now after you've essentially waived three years of this covenant without taking any corrective actions. This is known as a "course of dealing" issue. If the bank never even issued a default / reservation letter on this covenant in the past, you'll have very little basis to do so and enforce that condition now. You should tread lightly and engage your legal partners to assist. You may be able to send a notice to the borrower that they are in violation of the default, but the bank will have little ability to raise the rate or take other action for this first action. I would consider a modification that amends the covenant or gives a minor concession so that the loan is redocumented. That will allow the bank to appropriately and timely address covenants as they arise in the future. Good luck!

Optimizing an Exit Relationship

QUESTION: I'm a new workout officer and I was just assigned a $3.4 million real estate loan secured by a commercial building on a well-traveled thoroughfare in the suburbs of a major city. The loan is currently paid as agreed, but the property has lost tenants recently and is set to violate their DSCR this year. This was a stretch deal for a personal friend of the former bank president and there is limited sponsorship to right-size the loan or support any losses. We also are saddled with a rate that is significantly below-market and the loan doesn't mature for another six years. New management doesn't necessarily want to keep this relationship. What is the best course?

JASON: Since you've indicated management has designated this relationship as an exit relationship, I would strategize how to get the best resolution on a net present value basis. Given this loan is at a low fixed rate and is now graded criticized, your bank is likely losing money on it, given the increased loan loss reserve required on this asset. I would seek a resolution in two parts:

First, at the actual event of the default for the DSCR (once you receive financials from the customer and test them to verify a covenant has been violated), declare the default and negotiate with the customer to either: a) change the rate to the current floating rate or b) reduce the maturity to six to 12 months while delivering the exit/ refinance message.

Second, once the modification is closed/booked, market the loan to be sold to a distressed buyer. Yes, you'll be taking a loss on the asset at that time, but the loss will be lessened if you increase pricing and/or reduce maturity. On a net present value basis, the bank will achieve a better result from the loan sale than by holding the asset at the higher reserve on a long-term basis with a higher risk of further deterioration to non-performing status. If the loan stops paying and you're faced with non-accrual and potential litigation, the sales price you'll receive from a distressed debt buyer will be much lower than had you sold earlier. Your first loss is often your best loss, especially on a standalone deal with limited future improvement or opportunity for new business.

The Workout Window: Stressed Out About Office Space
By JASON ALPERT, CTP, CRC
The RMA Journal, February/March 2024

Insights into Special Assets and Situations from a Workout Leader.

QUESTION: My bank has a $2.6 million real estate loan secured by a Class B office building in a mid-size city. We originated the loan four years ago at a 75% loan-to-value (the valuation was $4 million) and our sponsorship is a well-known real estate developer who is exposed with other similar properties in the market. We have a fixed rate loan, but the maturity goes out another six years. My credit team is worried about the state of the office market and the performance of this loan with all the issues we read about in the office sector. Any advice?

JASON: Office CRE loans are certainly an area of heightened risk as remote work remains common post-COVID and companies downsize their space in response. (Bankrupt WeWork's struggles, which are adding vacancies in some markets, aren't helping either.) Values will decline in this sector for the foreseeable future—until the market stabilizes or companies (tenants) decide to take on more space.

The main question is: What is the customer's financial status and the property's operating performance? Assuming that the financial monitoring and covenants on your loan are not robust, to properly assess the risk, you should request financial as soon as possible. Most bank documents usually contain catch-all language that would require the borrower to provide statements as reasonably required. Put your request for information (rent roll, operating statements, tax returns, personal financial statements, and a contingent debt schedule) in writing and require the borrower to remit back to you in 30 days. If they don't, you may have a default on your hands. But first consult with your internal legal partners. Additionally, you may determine that ordering a new appraisal is warranted (and perhaps allowed under your loan documents, with the borrower to reimburse the bank for the appraisal's cost).

Even with a new appraisal that shows that the property's value has declined, assuming the loan payments are made as agreed, you may not have any defaults (unless there is language covering a re-margin default in your loan documents). If the property is struggling under a 1x debt service coverage and the personal guarantor is not able to demonstrate continued support, you may have a criticized asset that should be transferred to your workout team for further servicing. Note: Based on the fact pattern of the question, there are no financial covenants, so even if the property shows below 1x it is not an event of default under the loan documents.

Revolving Line of Credit Concerns

QUESTION: I am handling a $1.25 million revolving line of credit with $600,000 that is outstanding. The borrower is in the consumer disposable goods industry and our line is unmonitored. The line matures in four months, but we have not received any updated financials from the customer, who has become unresponsive. Bank management is concerned that the borrower may draw the remaining availability. Can we limit the borrower's drawing under the line so we aren't more exposed?

JASON: Absent a default, there is little you can do to stop the borrower from advancing on this facility prior to maturity. You certainly do not want to freeze their ability to draw without a declared default because that will create a "lender liability" issue that will most likely result in more time, costs, and potential litigation for the bank. I would recommend that you thoroughly review the loan documentation and engage your internal legal partners and workout team to determine whether anything proactive can be done that could limit the exposure. For example, there might be an opportunity for the bank to address the borrower's failure to provide financials (including aging schedules), failure to rest the line, or other defaults.

If no defaults exist, and given the customer is unresponsive to your requests, perhaps the best course to reestablish communications is to send a formal information request. It could cite the pending maturity as the pretext for the letter and state that without transparency and information you will not be able to entertain the renewal. Give 30 days to reply. If there is no response, then strongly consider a notice of non-renewal. (You are giving the borrower 90 days' notice, which should be reasonable time to replace the line at another lender.) Sure, this might run the risk that the borrower panics and draws the remaining portion of the line, but assuming they don't fraudulently transfer the assets out of the entity, the company will have that cash available to pay down the line as a condition of any short-term renewal. (Which, I'd imagine, would be the case given they aren't behaving like a responsible long-term customer.)

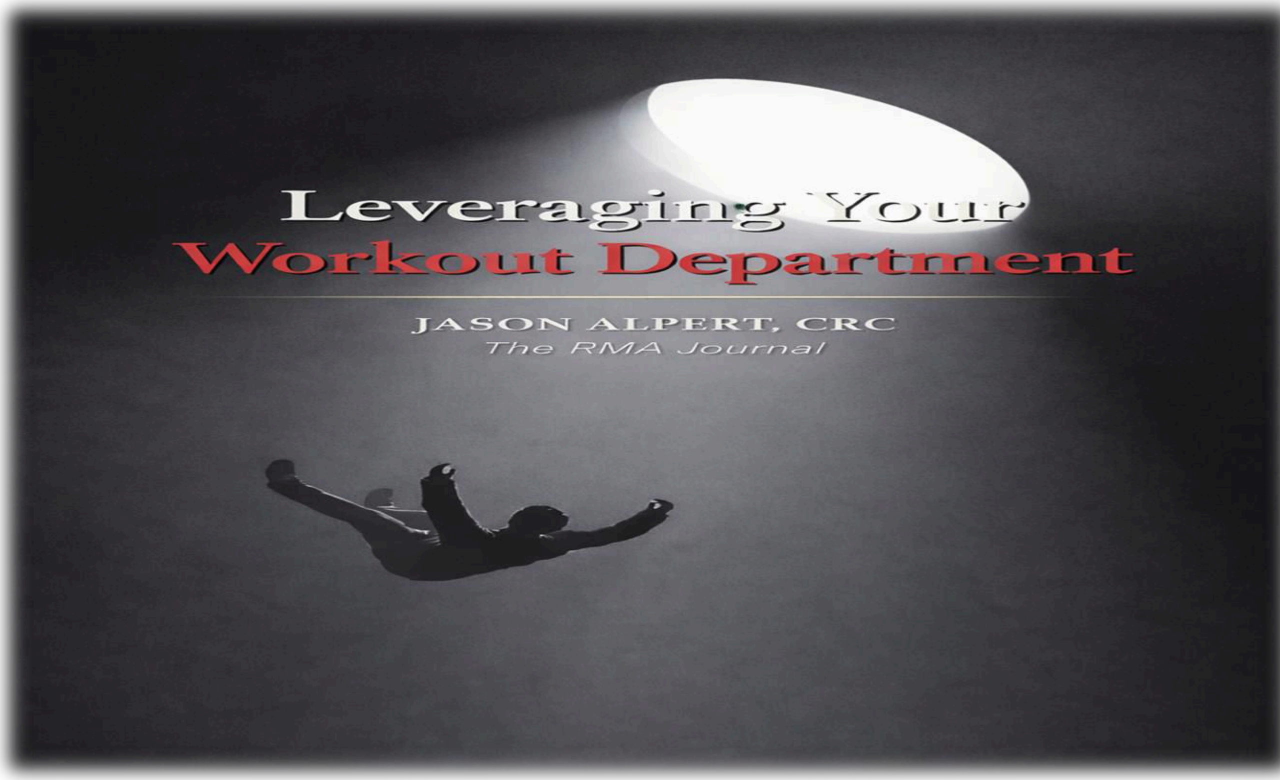
Handling a Habitually Late Borrower

QUESTION: If a loan is 60 days past due (covering two missed monthly payments), do we have to send it to workout? This borrower eventually pays, but I have to physically drive out to their business and meet with them to stress the importance of the payment—which usually comes in right before it gets to 75 days past due. I'm starting to get tired of this conversation with the borrower (and having to explain the situation to my manager).

JASON: You have a major early warning sign, if not a straight up non-performing loan, given the customer is habitually past due and it takes a special e ort on your part to have them to come up with funds to pay. The borrower is demonstrating a severe cash ow issue. You should immediately work with your management, credit team, and legal/workout partners on transferring this asset to workout. There is a high risk that this customer is distressed and you have a criticized asset on your hands that needs immediate intervention by your professional workout team. Finally, the opportunity cost of you continuing to spend your time begging and pleading with this customer would be better spent focusing on new prospects and current customers that need your financial expertise and new products. Good luck!

Workout Strategy, Decision-Making & Value Maximization

Choosing the right path when distress is unavoidable



Leveraging Your Workout Department
By JASON ALPERT, CTP, CRC
The RMA Journal, June 2019

"SEND THIS LOAN to our special assets department." Those words can send a shudder down the spines of most bankers, who immediately visualize the destruction of valued customer relationships they have spent countless hours cultivating.

Much like a country's nuclear arsenal, the workout department is thought to be the option of last resort when managing a lending relationship. However, workout bankers should be viewed more like a bank's special forces. They are a well-trained and focused team that analyzes the facts and leads the mission to resolve problem loans with as little collateral damage as possible.

To correct the misperception that special assets are the black hole where relationships go to die, banks can foster a positive working relationship between the line of business and the workout department, generating an atmosphere of mutual trust and removing the fear surrounding the department.

The cross-pollination that occurs between the line of business and the workout department can strengthen the credit skills of the line banker and improve the workout lender's understanding of the revenue-generating pressures facing the business. Banks are best served, both from a risk mitigation and customer management standpoint, when they strategically include their workout professionals in all aspects of the lending relationship, not just when a loan defaults and the deal falls apart. Lenders who engage their workout team at loan origination, employ them during portfolio management, and enlist them to educate their partners in the business can avoid unnecessary risk and stem potential losses to the bank.

Origination and Underwriting

In today's competitive environment, many lenders are hard pressed to find solid, creditworthy deals. Furthermore, they are often vigorously competing for them with other banks. In the race to book business, some lenders may be tempted to take on riskier deals in order to generate sales. They may prospect in new or unfamiliar industries, stretch on loan structure or security, and consider other, more "creative" deals.

In an atmosphere of irrational exuberance, the bank's workout specialists can be the credit department's second opinion on the deal's risk profile. Given their history with resolving distressed-debt situations, experienced workout lenders have an innate ability to project the downside of a deal.

For example, a banker with limited experience in lending to hotels or golf courses could reach out to the workout team for help in understanding the downside in these industries. Hidden issues not reflected in the f financials or appraisal—such as the hotel's property improvement plans to keep the valuable franchise flag, or the maintenance costs to be incurred by a golf course in the event of foreclosure—are potential pitfalls that may shed new light on a prospect. If nothing else, with the assistance of the workout department, the line banker can attempt to mitigate these potential risks and be ready to discuss them with the borrower and, more importantly, with the Credit Committee.

Moreover, preflight discussions with the workout department can also uncover the true nature of the potential collateral and its collect ability in a workout scenario. Typically, these issues surface in loans to nonprofits or churches, as well as firms that do extensive business with government entities. For instance, some bankers believe that if a loan is lowly leveraged—say, a sub-50% loan-to-value for a church—then that loan is money-good and the deal has minimal risk. However, in almost all nonprofit lending, the bank must consider the reputational risks associated with the loan, which often preclude the bank from foreclosure of the col lateral unless there are extenuating circumstances like fraud or theft.

Given that nonprofit loans are usually nonrecourse, eliminating the secondary source of repayment puts additional emphasis on the primary source of repayment, and the line banker will need to analyze its reliability carefully. A discussion with the workout department may make clear to the lender that, in the event of de fault, the bank would be hard pressed to collect from the collateral. Indeed, in this scenario, the bank would have to either provide a steep discount to the customer in order to sell the property (even if the loan is well secured) or abandon the collateral entirely—in some cases even "donating" the col lateral back to the nonprofit in order to eliminate the reputational risk.

These types of situations are not limited to real estate loans. A similar scenario would apply when the bank has provided a working capital line of credit, secured by accounts receivable, to a company whose customers are primarily government entities. If the bank were to attempt to collect from the accounts by requiring the entities to remit payments directly to the bank, the funds may prove uncollectable, as government entities do not typically inject themselves into two party disputes. Bankers who extend a borrowing base on the strength of the receivables and the perceived creditworthiness of the government entities could be hugely disappointed if the receivables evaporate or if the bank fails to capture the funds in an adversarial collection scenario.

A similar situation can arise with medical receivables. Privacy restrictions and certain laws make it extremely difficult to collect on these receivables, so experts from the work out area should be consulted. In addition, workout professionals can help underwriters identify the protected asset classes of individual guarantors that are exempt or excluded from collection. In some states, the guarantor's retirement assets, homestead residence, and other assets are exempt from creditors, and bankers that relied on those assets in underwriting could be in for a surprise when the borrower files for bankruptcy. The bank's claims are discharged, but the debtor retains the homestead and 401(k).

A bank can effectively use its workout partners to seek assistance with the borrower's legal organization, loan documentation, and other necessary items to ensure enforceability of the loan terms as agreed to by the borrower. While the workout department is never a substitute for legal counsel, it can help ensure that certain conditions and covenants are included and have teeth. For instance, a specialized and heavily negotiated covenant that departs from traditional documentary language may benefit from a workout lender's review. That individual's experience in testing and defending financial covenants in cases involving adversarial borrowers and skeptical judges can be valuable.

A workout department can also support the line of business by recommending that certain documentation be included in the closing package to help ensure the security of the bank's position and collectability of the collateral. For example, ancillary but important documents such as landlord waivers (allowing the bank access to collateral stored in a leased facility) sometimes get overlooked in the credit approval or closing package, but their inclusion is critical to the bank's ability to access and liquidate collateral. Banks are staffed by knowledgeable lenders, experienced credit leaders, and expert attorneys, but sometimes it requires someone with a workout eye to catch potential blind spots in documents.

Portfolio Management and Early Warning Guidance

Beyond the preflight, origination, and review of a new credit, a bank's special assets department can provide valuable insights on deals while they are being monitored and serviced by the line of business. The workout professionals can advise lenders on ways to obtain complete information, interpret negative news or financial reports, and craft a reasonable response to various problems.

Moreover, the special assets department can be instrumental in incorporating either a formal or informal early warning system that can help the bank and its portfolio managers discover potential problems and, more importantly, take appropriate action.

In an informal early warning system, lenders reach out to special assets officers on an as-needed basis when certain red flags signal the need for guidance. More formal early warning systems would incorporate periodic meetings, mandate special assets lenders to participate in watchlist reviews, or require workout to opine on certain actions or strategies (for example, issuing default letters or reviewing watchlist credits).

The informal early warning programs rely on lenders raising their hands and seeking their workout department's guidance when they run into issues or receive negative news. Bank management must encourage lenders to identify problems on their own, and it must reward those who have the courage to seek guidance and outside perspective in resolving them.

For its part, the workout department must adopt a spirit of collaboration. Furthermore, workout officers must minimize judgment on the nature of deal or the team that originated it. For instance, only when lenders are assured that their business acumen will not be second-guessed and that the deal's origination won't be subject to Monday morning quarterbacking will the necessary candor be established and allow for a robust discussion.

During this dialogue, the lender and special assets officer will dissect the looming issue and construct a risk mitigation strategy to resolve it. Workout officers can even lend a hand in meetings with distressed borrowers by suggesting corrections and restructuring plans. Extreme care must be taken by both the lender and the workout professional not to incur any lender lability in these meetings. (Most special assets lenders are highly sensitive to and careful to avoid lender liability.)

A formal early warning system establishes an official portfolio review process that includes the workout department and possibly requires its concurrence on adversarial or collection-type actions. Every bank manages its loan portfolio and conducts periodic reviews of its assets; however, banks are best served by including their special asset professionals when assembling their watchlist of criticized (but not yet transferred to workout) assets. The purpose of including a workout representative is not for the special assets department to "prospect" for new loans to manage, but for its personnel to opine on the current status of a loan and to suggest strategies that would strengthen the bank's position.

Say it is determined during a portfolio meeting that a loan has a nonmonetary default (such as failure of a covenant or some other condition of the loan). Rather than the bank providing a blanket waiver of that default for free or at a minimal cost, special assets could coordinate a strategy that would obtain alternative consideration in exchange for a default waiver that would strengthen the bank's position going forward (additional collateral, a guarantee, a pledge, etc.). Additionally, a special assets perspective on future business performance or loan payment can be helpful to portfolio managers as they consider the proper grading and course of action for the relationship.

During these review sessions, strategies can be developed for those higher-risk loans that the bank no longer wishes to maintain. The line of business provides a soft exit for a facility or relationship, allowing the bank to save face and avoid the borrower's traumatic transfer to special assets. This is especially valuable for those multifaceted relationships where a specific loan or borrower is not necessarily desired, but it would benefit the bank to retain ancillary services such as deposits, treasury, or consumer debt.

A soft exit, assuming that the strategy developed between workout and the business is followed and the latter can manage the level of the loan, can be a useful tool for resolving certain relationships without the sting of a special assets designation. However, if any further issues arise with the loan during this interim management—repayment problems, further defaults, or something similar, the loan should immediately be transferred to workout for final resolution.

Naturally, some deals discussed in these watchlist meetings will need to be formally assigned to workout for resolution. However, with the visibility afforded these deals and with special assets officers in attendance, a prearranged downgrade and warm handoff strategy to workout can be facilitated, limiting the downtime during the transition. Including the workout specialists on watchlist deals can help build their familiarity with the deal and ensure a quick triage if the deal is downgraded to workout. The faster the deal's transition to the workout department, the quicker the relationship's problems can be addressed, solutions instituted, and collateral or repayment preserved.

Overall, an open and honest working relationship between the line of business and the workout department, one that engenders transparency and dialogue, can be an effective risk management tool that catches potential issues before they become major defaults.

Training

Many special assets departments are staffed by highly experienced bankers who are knowledgeable in credit as well as specific industries or loan types. It would be wise to invite these professionals to share their wisdom with line bankers—either by holding formal training seminars or distributing summaries of past workout resolutions (these "spilled milk" stories must not identify specific individuals, only present facts and key takeaways). It is important that workout officers include events showing success in helping to retain the relationship after its restructuring and rehabilitation. These successful cases are critical to dispelling the notion that special assets is a collection-only shop.

Even informal lunch-and-learn or panel discussions can be valuable in raising a variety of workout topics, which are essentially a discussion of risk and the prevention of loss. Also useful are presentations by workout professionals on litigation and bankruptcy, as well as more mundane topics such as loan documentation or a focus on specialized industries such as nonprofit lending. Furthermore, periodic education from the special assets department keeps the lines of communication open, helping to reinforce the relationship between lenders and workout officers, and, hopefully, encouraging and reinforcing the need for lenders to reach out when they foresee or encounter a problem.

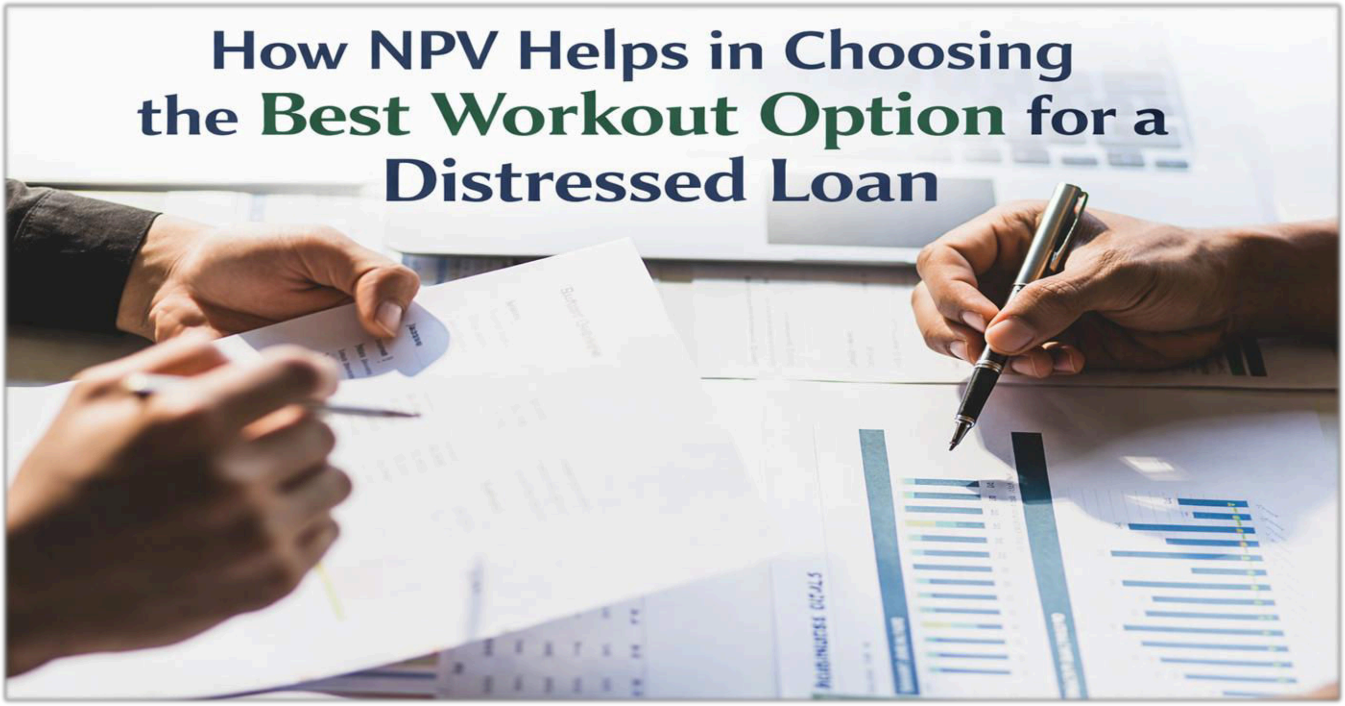
Another valuable form of instruction is to have lenders "ride along" with workout officers during meetings or mediations with debtors. It can be enlightening for lenders to witness ways to conduct a contentious meeting with an adversarial borrower. Moreover, it provides the bank with a critical "second witness" to help verify the nature and contents of the meeting should a court dispute occur.

By making presentations to lenders, special assets professionals can highlight the work they do for the bank, while bringing various credit and risk issues to the top of bankers' minds. And through training sessions, workout professionals can emphasize good lending and risk mitigation throughout the line of business, helping to stop bad habits from morphing into actual loan or reserve losses for the bank.

Conclusion

A bank that actively engages its work out department throughout a loan's life cycle and encourages robust partnerships between lenders and workout specialists can improve its risk management practices and lower its loan losses.

By using the knowledge and experience of the special assets department and viewing the servicing of a relationship through a workout lens, lenders can identify red flags and take appropriate actions before issues become problems and eventually losses. And by leveraging the workout department, a bank can lower the collection and reserve costs imposed on loans formally assigned to special assets, improving the returns on the bank's portfolio.



How NPV Helps in Choosing the Best Workout Option for a Distressed Loan
By JASON ALPERT, CTP, CRC
The RMA Journal, May 2024

IN THIS TALE that's been crafted for instructional use, a community banker is thrown into the world of workout. Lacking experience there, he seeks help from a special situation specialist and learns that determining the net present value of collateral is key to a loan workout win.

In 10 years at a mid-sized community bank, Willie Malone worked his way up from underwriter to relationship manager. Over time, and with his employer reeling from a spike in criticized assets, he unexpectedly found himself managing workouts, where he had little experience and often felt overwhelmed. The 20-plus deals on his desk languished in various stages of distress and collection as he searched for guidance on how to sort them out.

Malone called Michael Kilroy, whom he'd met at an RMA industry event. Recently retired, Kilroy had 35 years of experience working on special-situation assets and knew a thing or two about troubled loans. He offered Malone some simple advice: stay out of lender liability situations; demand transparency from borrowers; and use Net Present Value (NPV) to get the best workout result for your bank.

This last bit puzzled Malone. He understood NPVs but wasn't sure how to apply them to distressed workouts. Kilroy explained that in these situations, NPV simulations could show how to get the best outcome from the loan under different workout scenarios and convince leadership of the best path forward, to boot. Malone was all ears.

To calculate the NPV of the loan under different workout approaches, you would forecast future cash flows from each strategy, deduct the expected costs to the bank, then discount the expected cash flows back to today's date. The scenario with the highest NPV is the approach that would win, Kilroy explained.

The process itself had its benefits, too. First, to do the various NPV calculations the bank would need to collect and organize all the documentation relevant to the loan – a necessary but tedious task bankers would otherwise avoid. Second, the bank would begin to understand better the intrinsic value of the asset. Finally, and most importantly, by pinpointing the value of its various approaches to a workout, the bank would be in a much stronger position to negotiate.

"Please explain," Malone implored.

Collecting Documentation

Malone knew he'd need to go through the loan documentation with a fine-toothed comb. But he hadn't considered items like the marketing time outlined in the recent appraisal document though he understood why it was important for estimating how long it would take to liquidate collateral in a foreclosure scenario. Nor had he explored items he might need from third parties, like simple market rental fees to compare against the assets' current leased rates to assess future rental income. He realized he needed to dive deeper into the guarantor's personal financial statements to see what assets were exempt from collection under bankruptcy or state law and estimate guarantor cash settlement payments. Malone was beginning to understand how collecting information was important to getting the full picture of the situation and how the NPV process could help him.

Assessing the Intrinsic Value of the Asset

Don't confuse the intrinsic value of an asset with its accounting value, Kilroy warned Malone. The latter is usually the legal or book balance of the loan less any mark-to-market charge-o s or reductions due to interest payments applied as principal, while the intrinsic value should only be used for internal purposes in considering the strategic value of the loan. It can influence senior leadership to consider different paths to resolving the loan that could achieve the best returns for shareholders.

Understanding Your Negotiating Position

NPV can be a powerful metric for negotiations, Kilroy said. If the bank gains the most benefit from the scenario with the highest NPV, then ranking scenarios by NPV can make decision making easier. In the case where the NPVs of two scenarios are essentially equal, the bank can offer the borrower options and, based on which it chooses, understand what the borrower's intentions are for the relationship.

To better explain his points, Kilroy continued with examples. He cited a distressed commercial real estate loan that was habitually in default but had a loan-to-value of 60%. He ran NPV calculations considering various workout scenarios and found that selling the note at a 12% discount would yield a better NPV than either a refinance or a foreclosure. At first, his Credit Committee wasn't buying it. Why would the bank sell a loan that technically was performing and was well secured? Kilroy reminded the committee that the loan was already on the books at a 9% loan loss reserve, and that to make up that 12% would take two to four years under the best of circumstances. Getting money in the door today was the better option, he convinced them, repeating the old workout adage that "your first loss is your best loss."

Then he described the case of a real estate investor/sponsor with several different loans at the bank. The customer had defaulted on one and wasn't working well with the bank to resolve it. Through an NPV analysis, the bank determined that a restructuring and a discounted payoff had the same value. It shared these options with the borrower's attorney, in part to understand how the borrower would approach the negotiations. Selecting the discounted payoff would signal the borrower's desire to forgo the asset and take the path of least resistance. Choosing restructuring might signal the borrower's willingness to fight hard to keep the asset, including potentially ling for bankruptcy. It's better to have options, Kilroy emphasized, rather than being hemmed into one.

Getting Started

Malone was now a believer. He was excited to bring what he learned to the bank and start applying it to those 20-plus troubled loans. Using NPV provided a solid framework for solving his problem loans and a structured approach for negotiating the best results for his bank and his customers.

But, where to begin? Malone wondered. As in so many lender/borrower negotiations, it starts with the relationship and an assessment of the bank's bargaining position. Collect all the loan information, ask the company for its latest financials, and order an asset appraisal. If the bank is missing information or is poor at servicing the loan, it might be better to provide a short-term forbearance on the loan to gain cooperation, x the documentation issues, and obtain mutual releases. In some cases, the bank might even have to grant concessions to perfect collateral or get waivers of claims and defenses with servicing problems or lender liability claims.

If the lender is in a strong position in relation to information and servicing, then the bank has the luxury of considering the pure relationship implications of the workout. Is this a customer the bank wants to keep (in which case a modification may be more appropriate) or is it an exit situation (which might lead the bank to sell the note or foreclose)?

Building a sound model is key, Kilroy explained, especially given model validation requirements. Lean on your modeling team to support you in creating the tool, he offered. Excel has an NPV calculator, and your modeling team can add essential inputs like the discount rate.

Now, to the hard part – developing the cash ow and other assumptions for each scenario to ll out the model. These questions must be answered:

1. What are the viable scenarios for this asset (restructure, foreclosure, note sale, A/B/C note restructure)?

2. How long will each scenario take to fully resolve the asset?

3. What are the cash inflows from each scenario? Under a restructuring, for example, cash inflows would be the debt service payments and balloon payoff under a re nance. In a foreclosure, in flows might come from controlling the collateral and any rental income. In the case of a note sale, proceeds would come from the sale.

4. What are the cash outflows from each scenario? In a restructuring, the only cash outflows would be the bank's overhead; any expenses incurred would be collected from the customer. In a foreclosure, the cost of collections includes legal expenses, third-

party reports, advanced real estate taxes, and forced placed insurance. Make sure that common expenses, such as servicing costs and bank overhead, are included for each scenario for a true apples-to-apples comparison.

5. What is the NPV of the cash flows for each scenario? Use the cash inflows minus the cash out flows projected for the duration of each scenario and discount each of the net cash flows back to present value. To be conservative, the discount rate should represent either the bank's cost of capital (equity return requirement) or the loan-loss reserve of the asset.

6. Do any of the assumptions have an outsized effect on the results for each scenario? Keep in mind that NPV, given the time value of money, reflects a greater impact from inflows or outflows that occur earlier in the projection.

With a new outlook on his portfolio and practical steps to get started, Malone thanked Kilroy and prepared to say goodbye. Before he hung up, Kilroy left him with some final thoughts: "Finance is and isn't simple. You can value any asset using an NPV. The problem is that it's sometimes more art than science. Setting your assumptions, understanding the variables, and modeling the timing of cash flows can be a shot in the dark. But at least now you have the tools and perspective for tackling your loan troubles."

An Exercise: NPV in Practice

Let's look at an NPV scenario on a $1.5 million loan secured by a $2 million shopping center. with the property breaking even on a cash ow basis. We want to consider the best option among (i) deed-in-lieu settlement; (ii) foreclosure; (iii) note sale at 85% of PAR; and (iv) restructuring on an A/B Note basis. The bank's monthly overhead is 1.5% of the outstanding loan balance and its discount rate is 17%, or its loan loss reserve.

Major assumptions and result:

1. 6 months to get the asset followed by 18 months of marketing / liquidation. In flows from net rental income for 24 months until liquidation (about $10k / month). One-time legal and other costs of about $85k at start of analysis. NPV: $1,266k.

2. 12 months to litigate and 12 months to market and liquidate the asset. Small guarantor payment of $50k after 3 years of litigation. $75k in upfront costs and ongoing legal of $3k / NPV and payment of real estate taxes prior to eventually collecting rental revenue. NPV of $1,073k.

3. Note sale at 85% of PAR and 3 months to market. NPV of $1,204k. 4. A/B note restructure for three years with A note at 8% / 25-year amortization. B note accrues at 10% interest (waived if paid o by maturity). Both loans pay off at maturity. NPV $1,171k.

4. A/B note restructure for three years with A note at 8% / 25-year amortization. B note accrues at 10% interest (waived if paid o by maturity). Both loans pay off at maturity. NPV $1,171k.

Helping Borrowers Help Themselves: The Case for turnaround Consultants
By KEN YAGER & JASON ALPERT, CTP, CRC
The RMA Journal, June/July 2025

WITH RECESSOION FEARS rising and economic volatility high, now is a good time for banks to revisit the tools available for managing troubled loans. One resource that's often overlooked—but increasingly relevant—is the turnaround consultant.

Having spent much of our careers in loan workout (Jason) and turnaround consulting (Ken), we've seen firsthand how this arrangement can lead to better outcomes for both borrower and lender—when used appropriately.

As you read this piece, keep in mind that, in most cases, a consultant can't be imposed unless the borrower is in default or the loan is transferred to workout. A court may also require a company to bring in outside help. But when signs of distress are present, lenders can and should encourage borrowers to voluntarily consider a turnaround firm. Early action can preserve relationships, protect collateral, and improve outcomes for all parties. In addition, it's been our experience that, should the situation worsen, bankruptcy courts often look more favorably on borrowers who take proactive steps to stabilize operations before filing.

This article offers a practical overview of how turnaround firms are engaged, what they do, when their involvement makes sense, and how banks can help borrowers take that step early—before a crisis limits their options.

Spotting Trouble: When To Consider a Turnaround Consultant

When a customer continuously exhibits signs of distress or cannot meet contractual obligations or loan covenants, a bank's suggestion that the borrower voluntarily engage a turnaround consultant may get more traction. A borrower may be slowly slipping into distress, tripping one covenant after another, and struggling with cash f low visibility. Here, a turnaround firm can help with reporting and cash flow management.

Other problems can occur quickly rather than gradually. For example, consider cases where:

- The cash flow drops due to sudden market correction.
- A firm with customer concentration issues loses its only client.
- A merger has gone wrong.
- Unexpected and significant higher costs have been incurred due to changes in regulations, litigation, or enactment of penalties.

An outside consultant could manage cash, optimize assets, and improve the allocation of resources during such calamities. This is where a lender earns their advisor status—by spotting distress early and recommending a turnaround consultant that can help facilitate solutions.

What Turnaround Consultants Actually Do

Turnaround experts can help stabilize distressed borrowers by providing services such as cash flow forecasting, operational restructuring, and stakeholder negotiation. Their capabilities vary, and every engagement depends on the borrower's specific challenges.

Some consultants focus on financial restructuring, identifying alternative capital sources to reduce the bank's exposure. Others target operational inefficiencies and help uncover cost-saving opportunities. In more serious situations, a turnaround firm may place an employee in a leadership role—such as chief restructuring officer —to rebuild trust with creditors and stakeholders.

Consultants are typically embedded with and engaged directly by the borrower. They work closely with management and ownership to understand operations, identify risks, and develop a customized recovery plan. In cases where liquidity is tight, their fees may be indirectly covered using bank-controlled cash or collateral. But because consultants prioritize rapid stabilization, their work often offsets the cost—especially when measured against the potential recovery of loan value. Even if the engagement is carried at a loss, it can be a reasonable investment in preserving long-term value for both borrower and lender.

The Bank's Role in Facilitating Consultant Engagement

Bankers are expected to serve as trusted advisors to their customers. But there are strict legal limits they must observe—especially when a borrower is financially stressed. To avoid lender liability, the banker's role is typically limited to understanding the customer's business and financial needs and offering appropriate financial products to meet those needs.

Still, in distress scenarios, banks can play a pivotal role by identifying risks early and recommending that borrowers consider professional support. A well-timed suggestion can help guide the customer toward a solution before the situation worsens. After all, a distressed borrower's volatility and need for vigilant servicing can strain lender resources. And because many borrowers don't fully understand how banks operate, inconsistent responses from lenders can lead to paralysis or panic, especially if the borrower doesn't know how the bank will react to each new piece of information or request. A breakdown in communication can erode trust and delay action, increasing the potential for losses. A turnaround consultant can help bridge that gap, creating a path forward that borrower and lender can agree on— and improving the odds of a win-win solution.

Overcoming Borrower Resistance

Even when a bank makes a strong case for early intervention, most customers are loath to recognize they are in distress. They may strongly resist spending money on outside help, especially if they believe the issues are temporary or solvable with internal resources.

Common objections include:

- "We've been in this situation before."
- "We already have an accounting firm that can provide these services."
- Or, simply, "There's nothing wrong."

Absent a default, banks have no leverage to require their borrower to engage a consultant. But if lenders truly understand the customer's business and industry conditions, they can make a compelling case that the "ounce of prevention is worth a pound of cure." Hiring a turnaround firm early can improve operations and help sustain long-term profitability.

Often, the concept of preventive action is hard for management to grasp— especially if they've historically always made payroll or view certain expenses, like staffing levels, as untouchable. Helping a borrower see the need for new thinking in the current context can be highly motivating. This is especially true in industries experiencing rapid change or existential threats.

Consider the example of trucking companies. In recent years, they have been beset by industry-wide overinvestment, falling demand, and rising costs related to interest rates, insurance, and drivers—squeezing cash flow in a highly competitive industry. At some companies, management may be tempted to "ride it out" (pun intended), but as the industry changes, the viability of certain customers, equipment types, and routes may not be sustainable.

A turnaround consultant can help distinguish between the loads that generate cash and those that don't, and then develop a plan that stakeholders—senior lenders, equipment lessors, and management—can understand as both actionable and valuable.

Case Study: Preventing a Seasonal Collapse

A banker grew concerned about a seasonal business that imported and sold Christmas-related merchandise. With long off-season exposure and global shipping risk, the business had little margin for error. The banker asked the company to develop a cash flow plan, and a turnaround consultant was brought in to model the business's resilience. Once the owner saw the risks laid bare, they made key changes—adjusting staffing and purchasing to better align with cash flow. The company stayed afloat, and the banking relationship was preserved without ever entering default.

Matching the Right Firm to the Right Situation

When recommending turnaround consultants, fit matters. A firm that's effective in one scenario may be a poor match in another—especially if the borrower's business is small, highly specialized, or operating under tight resource constraints. To avoid overreach and lender liability, banks often provide borrowers with a vetted shortlist of firms. This allows the borrower to make the final decision while still ensuring a level of quality and relevance. But that list must be curated carefully. Firms should be suited to the borrower's size, industry, and complexity. Mismatches—such as assigning a boutique retailer to a high-cost national firm—can erode value and stall progress. It's also important to note that a turnaround consultant is not a vendor of the bank and is not subject to the bank's third-party risk management requirements.

Case Study: Matching the Fix to the Problem

A well-known regional shoe retailer with multiple locations was feeling the pressure of online shopping trends. Sales were down, and inventory turnover had slowed. The banker recognized that the leadership team had strong fashion instincts—but lacked the tools to manage the business's operational complexity. A turnaround consultant was brought in with a firm directive: simplify and stabilize. Instead of recommending an expensive inventory system, the consultant implemented basic KPIs and cash flow planning. The lighter, lower-cost approach aligned with the business's size and skill set—and helped turn the company around.

What Banks Stand to Gain

Turnaround consultants can provide the bank with detailed information it would not have otherwise, improving the bank's understanding of the borrower. For example, many turnaround firms have their customers project 13-week cash budgets and annual pro forma budgets. At smaller businesses with limited finance departments, these reports don't exist for the bank to analyze. Even when they do, they can be superficial or not especially useful to the lender, as small business CPA firms are typically more focused on creating financial reports and tax returns than on operational clarity.

While everyone understands what cash is, how it moves through a business can be a mystery to some borrowers. Further, how it connects to simple operational steps— such as invoicing, shipping, store hours, services delivered, purchasing, and even HR and team alignment—become hard to define and manage. Turnaround consultants can quantify the cash flow impact of seemingly disconnected activities. And not only do they strive to identify cash mechanisms and waste in a business, they can also tap relationships in the capital markets, allowing them to find new lending facilities or equity sources for the borrower.

Meanwhile, at the human level, a good turnaround consultant can help a business owner repair team chemistry and show employees how to better communicate business issues and processes. In a business that is under stress, relationships are often frayed. A turnaround professional can serve as an independent, unbiased arbiter in mediating long-festering issues and rebuilding bridges along a productive path. While this may seem minor when millions of dollars are at risk, in our experience a company that improves how it functions at the human level often finds the fastest and least-disruptive path to debt repayment.

Turnaround firms also bring insight into how a borrower should work with its stakeholders. Some distressed business owners try to leverage their situation by making statements like “we will just file bankruptcy” or “we’re going to the lawyers” in an effort to gain negotiating power with lenders. A turnaround expert can help lower the temperature, providing objective analysis and helping the borrower make more rational decisions that maximize value and recovery.

Further, turnaround experts may uncover inefficiencies or capital needs that the customer’s lender is in a position to solve. Assuming the bank wants to continue the relationship, these findings can lead to the sale of new products or cross-sale opportunities with other bank business lines. For example, a lender with a simple, unmonitored working capital line secured by a blanket UCC lien might suggest the borrower engage a turnaround expert after reviewing financials that show a maxed-out line, rising revenues, and flat cash flow. After digging into receivables and inventory, the consultant may suggest new policies or procedures that would make the company eligible for an asset-based lending structure—unlocking cash from collateral and allowing for sustainable growth. The bank, meanwhile, would be in a stronger position with better collateral monitoring and reduced credit risk.

While this kind of win-win outcome could, in theory, emerge from a normal conversation between relationship manager and customer, many smaller businesses lack the experience to ask the right questions. In our experience, the core concept of an asset-based lending model—one built on understanding and managing the balance sheet—is unfamiliar to many entrepreneurs. Turnaround consultants have often walked clients through not just expenses but working capital, embedding those mechanisms into the 13-week cash flow model to show how much cash is tied up in receivables and inventory, and how quickly those balances turn over during operations.

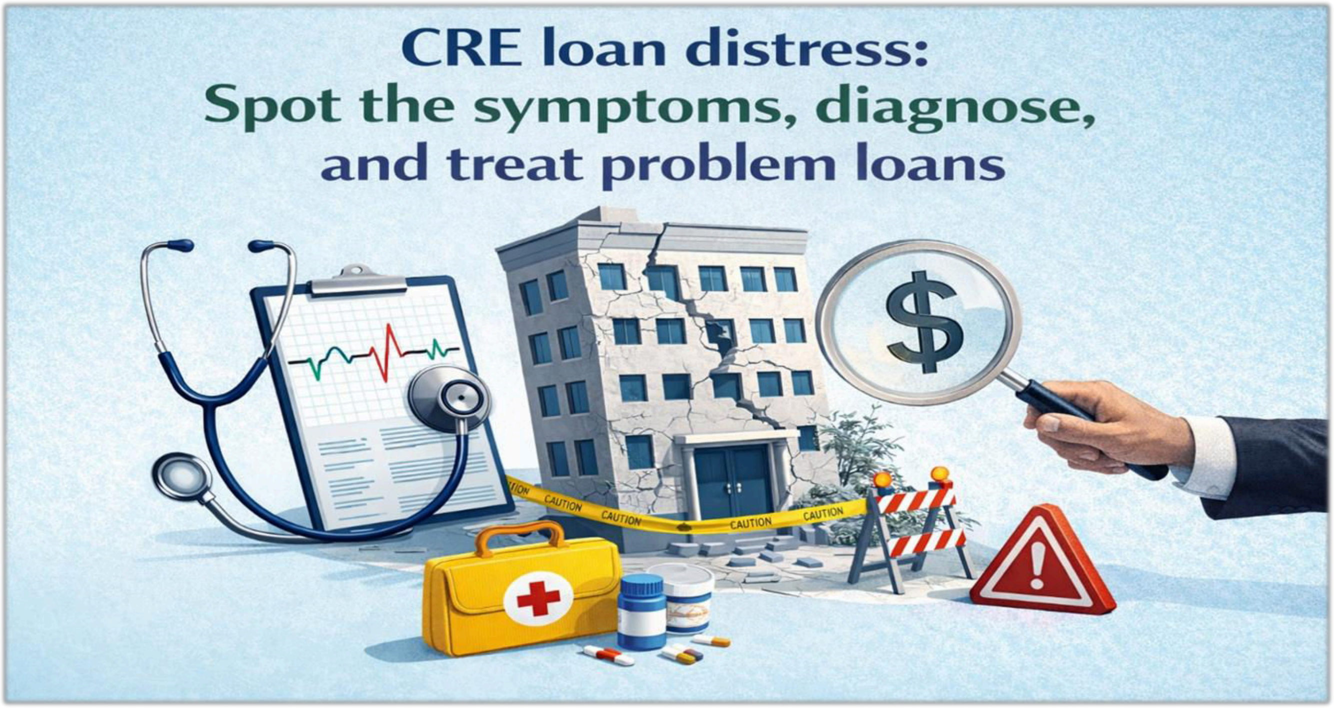
Once turnaround professionals have the attention of a small business management team, they can demonstrate how using an asset-based lending facility improves liquidity. In fact, many borrowers—once they understand their balance sheet— don’t want to return to standard unmonitored lines and credit cards. The learning can be steep, and it takes time to reach the “aha” moment, but with a professional’s help the payoff can be substantial.

Case Study: A Last-Minute Exit That Worked

A chain of fitness centers lost its founder, and with that loss came a cascade of issues: declining memberships, deferred maintenance, and mounting internal dysfunction. The bank saw trouble, but management remained in denial. Eventually, both sides agreed to bring in a turnaround consultant for a quick assessment. The report revealed serious problems—but also a path forward. Faced with reality, management made the decision to sell to a stronger operator, avoiding liquidation and protecting the lender’s position. Of course, sometimes even the best turnaround effort will not prevent a borrower from needing Chapter 11. Even in those situations, a turnaround expert can help analyze the financial implications of each option—a menu that borrowers may not be equipped to evaluate on their own. Important note: While turnaround consultants are sensitive to legal risk, they are not lawyers. Lenders should encourage borrowers to retain special counsel with restructuring expertise. A bank can support that effort by recommending legal professionals with deep experience in this space. Closing Thoughts In today’s environment of persistent uncertainty and volatility, even well-run companies may benefit from outside, independent professional support. Turnaround firms can add value for businesses that are struggling to compete or sustain profitability over time. For financial institutions, these firms can serve as critical intermediaries—helping preserve the borrower's ability to repay and supporting the customer relationship before it deteriorates beyond repair or ends in bankruptcy. Banks that maintain a list of turnaround professionals with a range of experience and cost structures are better positioned to help clients proactively address inefficiencies, preserve enterprise value, and protect the bank's exposure— creating the proverbial win-win-win.

Commercial Real Estate (CRE) Distress & Portfolio Risk

Managing repricing, regulation, and reality



CRE Loan Distress: Spot the Symptoms, Diagnose, and Treat Problem Loans
By JASON ALPERT, CTP, CRC
Abrigo.com, March 2024

How to respond to commercial real estate loan distress

Use these tips for banks and credit unions to identify and handle commercial real estate loans that are showing signs of being problem CRE credits.

Takeaway 1

- Engaging the bank or credit union loan workout team or an outside expert can help restore commercial real estate loans in distress or mitigate their impact.

Takeaway 2

- Address early warning signs of a distressed borrower immediately so you don't risk liability that could lead to the financial institution losing the CRE loan's collateral.

Takeaway 3

- To triage a commercial real estate loan in workout, first re-engage the deal team and conduct a comprehensive review of the loan documents.

Ailing commercial real estate loans?

Media organizations are reporting scary-sounding data, and the headlines scream about the most recent victims. Government entities are issuing advisories and guidance for addressing this unfamiliar phenomenon and for shielding the financial institution from the potential threat. Individuals and business owners are starting to contemplate the worst-case scenario and how it can impact their earnings and balance sheet.

Is the above scenario another pandemic akin to our recent COVID experience? No, it's the current situation in the commercial real estate market tied to the threat that distressed properties and problem CRE loans pose to investors, banks and credit unions, and the economy at large.

While no potential CRE "disaster" is comparable to the COVID pandemic in terms of the human impact, it is still a clear and present danger to our banking system and the economy.

CRE is now arguably the riskiest asset class due to a perfect storm of:

- Systemic changes in the way we utilize real estate (not just office, but retail, housing, and other sectors).
- Unprecedented increases in interest rates from an abnormally historic low-rate environment.
- Inflationary impacts on costs of various inputs.
- A wave of pending maturity events $2 trillion of CRE loans are reported to mature in the next years).

Consequently, all stakeholders of CRE assets are understandably nervous, including bankers and their investors who, due to the highly leveraged nature of CRE transactions, provided the bulk of capital financing the industry.

Bank and credit union leaders who recognize souring CRE loans with the potential to manifest like an illness in their institutions should engage their workout professionals/team. Doing so is akin to taking a relative to the doctor when sick or showing symptoms. The workout team can help lenders diagnose distressed CRE assets. Workout specialists (http://www.castlebarholdings.com) can also provide consulting and advice (treatment) that either helps alleviate the loans' distress (symptoms) and restore them to health or helps mitigate the spread of the "illness" to protect the health of the financial institution.

Here's how banks and credit unions with strong CRE risk management and who can identify weakening property loans, assess them, triage them, and assist with their prognosis and treatment.

Signs of potentially troubled CRE loans

Given the heightened and well-established risks that commercial real estate loans pose, banks and credit unions should be on high alert for any signs of sickness in their CRE portfolio. In this environment, any indication of early warning signs of distress from a CRE loan should be addressed immediately. Bring together the deal team, credit approvers, and workout experts to discuss and determine the grade and next steps.

Beyond a hard money default due to a payment or maturity event, early warning signs for commercial real estate loans typically manifest as a:

- Failure to pay real estate taxes.
- Failure to sustain adequate insurance coverage.
- Failure to maintain the property.
- New lien on the commercial real estate.
- Failure to deliver required financial information.

Each of these signs is a major commercial real estate red flag as it represents a lack of cash and resources to pay required obligations, mitigate catastrophic risks, and support value. Furthermore, failure to pay taxes and insurance is almost always an event of default, and the mortgage instrument provides the bank or credit union the ability to advance funds and force-place insurance to protect the collateral.

Additionally, any new liens on the property demonstrate cash flow issues with the property, especially if the financial institution was notified as required under the loan documents.

Finally, any failure to deliver required financial information in a timely manner (including rent rolls/operating statements) or any covenant defaults (e.g., debt service coverage, debt yield requirements, or loan-to-value maximums) all represent major issues with respect to the loan. They should be addressed immediately. Ignoring any actual defaults is unacceptable and creates liability for the bank or credit union because this "course of dealing" can be interpreted as the institution waiving its rights. The bank or credit union can even lose the collateral (in the event of a tax deed sale or casualty event with no insurance coverage).

Diagnosing next steps for problem commercial real estate loans

As stated above, once an early warning sign for a distressed commercial real estate loan is identified, there is an increased probability of future non-performance, or if an event of default occurs, it is imperative that the bank or credit union take appropriate and timely action. What should the institution do? Here are three actions to take:

1. Engage CRE credit partners

The institution's deal team should engage with their credit partners and determine if the CRE loan should be downgraded and more closely monitored.

2. Engage the workout team

If there is an actual event of default or a hard money default that cannot be resolved (missed payment(s) or maturity event that doesn't meet renewal policy), the deal team and credit approvers should engage the workout team for consultation and discussion. At this point, with the workout team involved, a diagnosis of the commercial property loan can be made as to the appropriate steps in protecting the financial institution and mitigating losses (either through further downgrades or even charge offs).

The workout team or expert will be able to approach the deal from an independent viewpoint and provide important feedback to the deal team as to current risks, future problems, and prospective strategies. Most loan workout experts are not in the blame game with their bank or credit union counterparts and are providing credible challenges as to current assumptions in order to determine the best course of action for a troubled CRE loan (similar to a doctor not shaming the patient while advising the best course of treatment).

3. Consult on potential treatment

After discussions, the group might determine that the issue is a short-lived, one-time event, and a waiver of default is appropriate. On the other hand, they may decide a more long-term and intensive solution is necessary, including a formal workout shadow arrangement or a full-blown transfer to the workout team. The former is similar to a doctor prescribing medication to take at home, while the latter is more like outpatient therapy and admittance to the hospital. If the illness of the property credit is significant, then intensive care is needed, and workout should own the asset.

The benefit will be that the workout specialists will have an independent and objective relationship with the commercial property owner since they didn't originate the deal. They have no preconceptions regarding the credit or the loan documents, and they also have experience in managing the riskiest of assets so they can forecast and strategize on the best course of treatment.

Triage CRE loans in workout

If the bank or credit union team determines that the commercial real estate loan should be moved to workout, or even if a formal consulting and shadowing relationship with workout is warranted, then the loan should be admitted to what's essentially the financial institution's emergency room. Typically, when a patient is admitted to the ER, vital signs are taken (current financial package), symptoms are closely observed (problems analyzed), new tests are ordered (new appraisals obtained and/or requests made for additional financial information), and the patient is asked probing questions to help in the diagnosis (interview with the borrower). A similar triage process and triage checklist can be administered in the case of CRE loan distress.

1. Reengage the deal team

The workout banker should reengage the deal team, especially the relationship manager who was working with the customer or member. Obtaining access to all of the loan documents and credit file is of paramount importance and the relationship manager can provide context and share any important email, correspondence, and servicing notes with the customer or member. At this point, the workout officer will conduct a full and comprehensive review of the loan documents (which are essentially the Bible governing the loan), including email correspondence, letters, or other documentation that may provide a "smoking gun" indicating lender liability or a commitment made about the loan (either directly or inadvertently). If there are weaknesses in the loan documentation or if any lender liability is discovered, the workout officer should engage legal partners and craft a strategy on how best to resolve it, first and foremost. The financial institution may also want to engage a lawyer to formally review the loan documents and title to verify there are no gaps or insecurities.

2. Meet with the borrower

A meeting should occur with the borrower to introduce the loan officer and workout officer (warm handoff – if possible) – hopefully at or near the collateral property. Note: I am a firm believer that a commercial property inspection must be conducted by the credit union or bank or its officer if possible. The on-site inspection can illuminate any issues with the neighborhood or the property itself (e.g., unreported vacancies, visible deferred maintenance, and busyness of the property). Some best practices for this initial meeting with the borrower, which can be contentious if the customer or member has never been sent to workout, are to:

- Have two bank or credit union representatives at the meeting.
- Take good notes and minutes.
- Email those minutes to all attendees to recap the discussion

Often, workout meetings can be difficult discussions, and if emotions run high or the borrower makes accusations, it is best to have a record of what was discussed. It is important to note that the introductory meeting will not resolve the issues but is more for explaining the role of the financial institution, the rules of the road for communication going forward, the issues that predicated the transfer, and to make requests for additional information needed (financial and otherwise) that will be necessary to work on a solution. Again, follow up in writing with the formal request for information, and be sure to include any and all parties to the loan (including co-borrowers and guarantors).

3. Re-underwrite the CRE credit

The loan workout team will essentially want to re-underwrite the commercial real estate credit, especially if the borrower is open and transparent in providing updated financial information (both current and projections). It is also at this point that the bank or credit union should obtain an updated third-party appraisal of the collateral, especially if the last appraisal on the real estate or other collateral is stale (older than 12 months old) or if there have been substantial changes to the property or surrounding market. Additionally, if the loan documents allow or if the loan has an actual declared default, the institution should obtain updated financial information from all guarantors (corporate and personal).

4. Revisit the loan grade

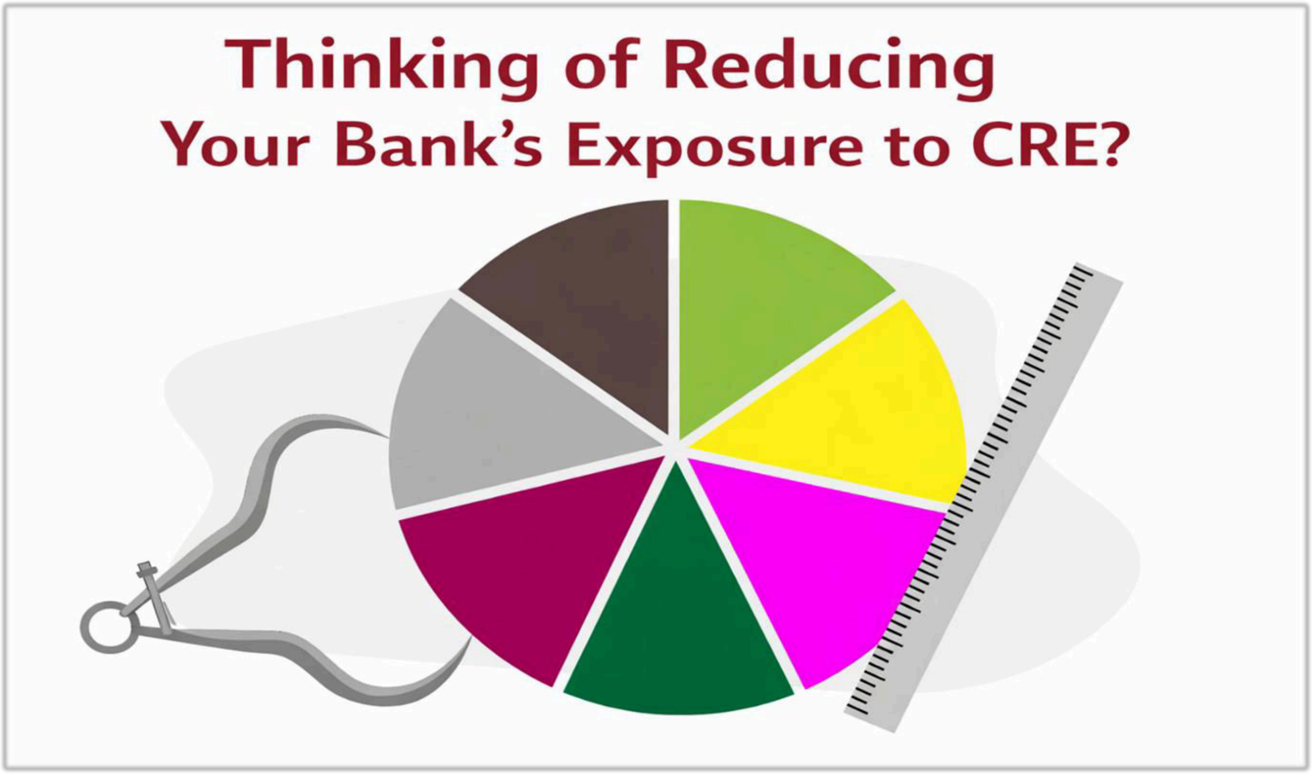
Once all of this information has been obtained on the primary, secondary and tertiary sources of repayment, the bank or credit union can revisit the current grade on the distressed CRE loan and strategize on the best course to resolve the asset. The financial institution should make the distinction of whether the credit is a “retain” or “exit” customer or member. The former indicates a strategy of rehabilitation and return to line of business. The latter indicates a collection posture that seeks to get repaid via the strategy that provides the best resolution on a net present value basis.

Make a prognosis for the CRE credit

Once the workout team has developed its recommendation and strategy for the problem CRE loan, it should follow up with the deal team to share findings and explain the go- forward strategy with the credit, i.e., the manner and course of treatment as to the patient.

If the deal team has reservations or wishes to provide a credible challenge, they should feel free to do so, as it is important that the entire bank or credit union team be on board with the ultimate strategy for the credit. Note, however, that the workout team must hold the ultimate decision. The workout group will want to keep its business partners in the loop as the deal and negotiations develop, especially in cases where the customer or member is politically or socially sensitive. It may be important to have a media relations or legal representative aware in the event any media inquiries are made regarding the CRE asset.

In essence, the workout team should be clear and deliberate in achieving its strategic objectives with respect to resolving the asset. Loan workout is not always a straight journey between diagnosis and the ultimate cure, as is the case with many medical treatments. The problem may be a chronic condition, or there may be many iterations, stop-and-starts, relapses, and even “death” via bankruptcy/liquidation. However, if the workout team follows the example set by the medical field’s principle of “First, Do No Harm” and follows a strict ethical path to achieving its desired resolution, the financial institution’s stakeholders will ultimately be best served.



Thinking of Reducing Your Bank's Exposure to CRE?
Here's a How-To on Portfolio Sales
By JASON ALPERT, CTP, CRC
The RMA Journal, June/July 2024

THE DRUMBEAT OF warnings about commercial real estate (CRE) loans continues to echo around the industry. Banks are worried, and regulators and market watchers are weighing in. The Federal Deposit Insurance Corporation (FDIC), for one, advised banks late last year of the growing risk CRE loans pose for defaults given declining commercial real estate values and signs of market dislocation. S&P Global Market Intelligence, meanwhile, estimated that 532 banks had exceeded their regulatory CRE limits as of Q4 2023.

While disruption and loan losses in the sector may seem inevitable as building leases mature and space empties, banks taking a deliberate approach to managing the risk can limit the impact of damaging asset deterioration. One strategy in particular – the portfolio sale – can help them dispose of potentially troubled loans in bulk, limit future losses, and return vital cash to the bank today.

The concept of a portfolio sale is simple: a bank selects loans that are no longer profitable or strategic, pools them together based on similar characteristics, and sells them in one offering to buyers in a large transaction.

The goal is to get a high er price, better recoveries, and better efficiency and execution than if the bank had sold those loans individually. Offering a bigger asset should, in theory, attract more buyers and more competitive bidding, and reduce the time investment necessary to sell all those loans.

Some banks lack the in-house experience to create and value the portfolio, and some have a hard time considering selling any loan at a loss, regardless of its risk exposure. While selling a pooled lot of loans is not for everyone, overcoming these blockers could make a big difference in loan-loss levels— and the bottom line—given the CRE challenges on the horizon.

Building a Team and Portfolio

A portfolio sale can involve dozens of loans and hundreds of buyers, so it's imperative that the bank assemble a team of professionals for the effort. It should include representation from a variety of disciplines across the enterprise. Most critically the team should include a workout leader/ banker, an internal legal partner, a compliance professional, and a loan operations manager. Others can join, as needed, throughout the process, based on the transaction's complexity.

This team will engage and communicate with stakeholders, establish best practices, and assemble the portfolio, taking direction from leadership on matters including the size and scope of the sale. Once general parameters are in place, the team can start inventorying loans and assembling data, some for internal use and some for external distribution to advisors and potential buyers.

These data are the raw materials from which you'll pick loans for the sale portfolio. Start by excluding from the list loans that are a 'hard no' based on policies or parameters from leadership. Review what's left for preliminary approval to proceed.

From here, you can start the fine-tuning. Generally, banks include loans they consider "non-strategic" based on considerations such as asset type, location, industry, risk, and customer relationship.

They might, for instance, decide to exit loans to office properties in central business districts. Or they might make a specific decision to sell the criticized loan of a particular customer. Defining the criteria for exiting or retaining a loan is important for constructing the sale portfolio.

Establishing a strong risk monitoring culture is also essential to understanding the quality of your portfolio and choosing the right loans to sell. The FDIC advises tracking and grading loans in real time. If a loan has the wrong risk rating, then not only will it skew your loan loss reserves, but it can lead to the wrong business decision on the asset.

Another possible metric to consider in your decision process is a loan's risk-adjusted net present value (NPV). The NPV should include all costs to ser vice the asset, collection costs (attorney / litigation fees), and asset protection fees (advanced real estate taxes, force-placed insurance, and auction and dis position fees in a replevin or foreclosure). \

A third-party loan sale advisor (LSA) can help in the valuation, structure, and pooling of the sale. It can provide experience, technology, and data security to protect sensitive information—and surface potential buyers.

The LSA can work with the client to set a timeline and marketing plan for the sale. It can also fill in administrative gaps and backstop banks by ensuring that all the necessary documents and files are available, underwriting the assets, and providing a range of reserve prices to expect from the sale.

Lastly, an LSA assembles a customized list of buyers from its network of specialized contacts and acts as market liaison for the seller. In this way the bank can focus on addressing issues related to the underlying loans and on servicing the assets.

Preparation for the Sale

Once the approvals and price indications are set, the sale team can engage bankers and their teams to kick off the sale process. This stage is perhaps the most critical of the transaction. It's at this point when loans are examined for their suitability in the sale by the relationship managers that know them best. It's also when critical documentation is collected.

Bank leadership can weigh in here on the significance of the sale and stress the role of the relationship manager in providing thorough review and disclosure. It's up to the team leader to review portfolio criteria and provide clear and detailed guidance to the relationship managers about how to satisfy their obligations in the process and when to speak up about loan issues. Legal partners should be available to provide answers to any legal questions that arise. Clear and consistent communication is important during the collection of loan and due diligence materials.

Depending on the complexity of the portfolio, the entire selling process can take 60 to 180 days. Given this amount of time, bankers must continue to service their loans as usual. For reputational and relationship reasons, they must not disclose to the customer that their loan might be sold.

If there are material changes to the loan during this time, such as loan modifications, defaults, waivers, and other changes to the servicing, it is imperative that those materials make it into the due diligence files. If they don't, the bank exposes itself to liability since they ultimately could affect the price and valuation of the loan. A buyer would have re course to the bank in the event the omission damages its ability to service and collect the loan.

For example, assume a loan is part of the portfolio auction, and the loan officer executes a discounted payoff agreement at 70% of the principal balance of the loan. If the loan buyer pays 80% of the unpaid loan balance to the seller but isn't aware of the discounted payoff agreement, it is losing not only the 10% difference it is obliged to honor as the new owner of the loan, but it can no longer collect the 20% principal balance. The bank would most likely need to make that buyer whole plus damages. That's why it's important to set a cutoff date for any loan modifications on assets included in the portfolio sale. If those modifications can't be completed by the cutoff date, then the loan should be pulled from the sale.

Making a Final Decision

Once the documentation collection and review phase is over, the LSA can underwrite the portfolio and provide reserve prices on the loans. In addition to setting the prices, it can initiate valuable portfolio and asset discussions that will be useful to the portfolio sale team as they draft the sale justification document for bank leadership to approve. In any loan sale resulting in a loss, the portfolio sale team should run an NPV analysis demonstrating that the sale at the expected reserve is accretive to the bank's shareholders. If the net price/ cash received from the sale is greater than under the alternative scenarios - such as retaining the loans or foreclosing the assets - then the sale is accretive and justifiable.

Furthermore, the portfolio sale leader should be engaging with the bank's accounting group to (i) prepare loans for the transaction; (ii) be ready to process the accounting impacts; and (iii) obtain the current allowance for credit loss on each asset. The allowance represents the loan loss reserve held on the bank's balance sheet for each asset and is based on the loan's grade and risk rating.

Comparing the loan loss reserve to the actual loss helps management reach a conclusion (assuming the loan grades are correct, and the reserve is accurate). In some cases, the loss incurred on the sale is less than what is reserved, resulting in a release of excess reserve once the loan is sold.

Once the bank finalizes its list of specific assets to sell, a sale justification memo is submitted to bank leadership for the necessary approval signatures. Accounting rules require that it move the loans to a held-for-sale status and that they are marked to market.

All stakeholders, the deal team, credit approvers, loan operations personnel, and especially the relationship managers should be notified that the sale was approved and will be launched to the market.

Sale Launch and Buyer Due Diligence

With the decision to sell made, activity shifts to the LSA, which will run the sale and engage potential buyers. The LSA will vet buyers and manage confidentiality agreements, but the bank should do its own buyer review for reputational or compliance risk. The bank will want to understand who the potential buyers are to make sure they do not represent a reputational or compliance risk. This can be done by running background/ litigation checks. The bank should exclude any buyers that have a history of improper col lection practices (outside allegations that are standard defenses offered by debtors during litigation), judgments, or criminal actions. The bank will have reputational problems if it sells its loan to a firm that doesn't respect or honor loan documents and/or collection laws.

Additionally, the bank should run internal checks on each buyer so it doesn't inadvertently violate federal regulations by selling a loan to a known insider or an affiliate entity (see Federal Reserve Regulations O and W). This may not be an issue for smaller institutions; large, complex institutions may have more exposure.

At this stage the marketing plan is key. The bank and the LSA work together to develop a strategy aimed at achieving the highest value through tac tics such as pooling like loans. Typically, pooling loans with similar characteristics attracts more buyers to those loans since investors tend to focus on specific asset types. Financial institutions, for instance, will only be able to buy performing loans given their regulations, while private funds may only focus on a region or specific asset class.

By segregating and categorizing these loans, it is possible to bring more buyers to a sale than there would be by only offering a "take-it-or-leave-it" approach (and, as noted, more potential buyers can translate into a higher selling price).

The bank can also allow combination bidding to drive buyers to buy several pools at once. However, the bank must be sure not to splinter borrower loans into separate pools as it can create a reputational problem if it sells multiple loans from the same borrower to separate buyers (creating a hardship on the buyer and potential conflicts within the loan documents).

Bid Day and Closing

Bid day is the climax of the sale process. Auction mechanics can differ based on the needs of the bank, the assets, and the recommendation of the LSA, but for mats include a "sealed bid auction," indicative and best final bids, and open outcry.

Once all the bids are finalized and reviewed, the LSA will share them with the bank, which has the ultimate authority over the bids it accepts. If the bids exceed the approved reserve amount, then a bank would likely move forward, unless it finds problems with the buyer(s). If certain loans didn't meet the reserve, the bank can choose whether to accept those bids, realizing that the losses will be bigger than expected and that it will need to secure additional approvals from leadership. At the final point of acceptance, the LSA will notify the buyers that they were successful, and they will hold the non-refundable deposits in escrow through closing.

At this point, the loans are technically sold. The bank cannot modify them. The allocation of the final net proceeds of the sale should include the loan operations and accounting groups so that once the cash proceeds are received the loans can be closed in the bank's systems.

At closing, all borrower billing should be suspended and electronic access to the loan cut off. Because the loan was not paid off, no collateral or confidential information about the sale can be released.

At this point, the bank will execute loan sale agreements, al longes, and any lost note affidavits and obtain original blue ink loan document files from storage. These should be sent to the LSA, which will hold them until the funds are received. On the closing date, the bank will need to send a formal closing no tice—also known as a "goodbye letter"—to the customer, notifying them of the sale, the new loan holder, and new servicing instructions. No one at the bank should discuss the rationale for the loan sale, only that the bank made an investment decision in the best interests of its shareholders. Additionally on the closing date, final data and loan payment history should be obtained and sent to the LSA and buyers for final reconciliation. Any payments received by the bank before or after closing should be monitored and remitted to the new buyer.

All Done

Prudent gardeners prune and trim their vineyards and or chards so that they can be more productive and bountiful. The same is true of banks that have stale or unprofitable loans on their books draining resources and freezing capital. Considering potential stresses facing the CRE loan sector, banks must be flexible about shedding problem assets.

While the industry may have considered these loans illiquid and hard to sell in the past, new technology and the development of secondary markets make it possible to manage loan holdings without offering huge discounts. The portfolio sale is one way to resolve asset issues efficiently and potentially deliver higher returns on assets than by selling loans individually. It can also help banks avoid the long and arduous process of rehabilitating a borrower or foreclosing on a loan.

The Workout Window: When Environmental Risk Surfaces
By JASON ALPERT, CTP, CRC
The RMA Journal, August/September 2024

QUESTION: Our bank is prudent about conducting appropriate inquiries and risk-based environmental diligence when making loans. But as we considered foreclosing on one of our borrowers, we found out hazardous waste had been dumped illegally on a property adjacent to our collateral. Should we proceed with the foreclosure and take possession of the property securing our loan? Or does the risk associated with possible contamination create even more risk than the potential loss on the loan? This has never happened to us before. Please help!

JASON: Proceed with caution! Assuming the borrower is in payment default (including maturity default) and proper default and demand notices have been issued to all borrower(s)/guarantor(s), your bank will need as much information as possible about the contamination before making the strategic decision to file a foreclosure lawsuit. This means ordering an updated Phase I environmental site assessment and, if needed, a Phase II to determine the extent to which your collateral has been contaminated by the illegal dumping. The last thing you want is to go through the litigation and realize you do not want to take ownership.

From a strategy standpoint, consider how to resolve this deal so that the customer ultimately leaves the bank. Offer a short-term forbearance on the payment default (and other defaults) to give time for environmental review and testing. As part of the agreement, obtain as much information as possible and pick up additional credit enhancement—collateral/guarantees—if it exists. Additionally, press the borrower to prepay the cost of all necessary environmental reports and updated valuations, or at least include it in the borrower fees within the forbearance agreement.

The borrower will likely want to share the reports with their attorney as they consider action against the adjacent owner. If you do share them, ask the borrower to sign a release letter beforehand stating that the bank disclaims any conclusions, warranties, etc. in the reports. Finally, as with any forbearance and modification, obtain a waiver of all claims and defenses in the forbearance agreement so no lender liability or servicing claims can be brought up as affirmative defenses by the borrower in a potential foreclosure litigation (if the property is clean or not impacted).

If the environmental reports show the property is impacted, assess the risk with your internal legal partners (and your other real estate (ORE) person if the bank has one)—and establish your risk appetite, if any, for foreclosing. If it seems too risky or expensive to assume the title, the bank might consider a few options. One is to sell the loan, with all proper disclosures, to a firm that buys environmentally compromised assets, though the discount on the note could be severe. The second option could be encouraging the borrower to refinance the property with a private lender. (Very few regulated lenders will take the collateral.) A private lender with higher risk tolerance may take the loan on, especially if there is a claim against the other property owner that can be quantified, awarded in litigation, and is collectable. Here, too, you may need to offer a discount to the private lender, but potentially not as large of one as in the note sale option.

Finally, depending on the jurisdiction/state, a special master or receiver could be appointed to market and sell the foreclosure judgment (you would still need to litigate) but the bank will not have to credit bid the judgment and will stay out of the chain of title. You'll need outside counsel from that jurisdiction who can walk you through the process. One last item: Make sure you are accounting for the loan correctly and taking any appropriate charge-offs to the asset given the updated condition/valuation. Good luck!

Throwing Good Capital After Bad?

QUESTION: A borrower with a fully tapped revolving loan let us know they are having a significant liquidity crunch. The company has done a good job scaling revenue, but has not translated that to cash flow. In addition, the drawdowns on the revolver over the past 18 months or so have been for acquisitions and more permanent working capital. As a result, the company is entering their busiest time of the year seeking the bank's assistance, with no liquidity remaining. Management has explained that savings from cost-cutting measures have not been realized yet, but they are optimistic they will improve profitability in line with the revenue scale.

Should the bank provide more assistance to a watchlist credit knowing that inaction will impact the company as a going concern? Is there a point where we stop throwing good capital after bad at the borrower? If so, what is that point?

JASON: If the revolver was expressly for supporting working capital needs, discuss with bank leadership the best way to address the borrower given its improper use of the line for acquisitions and permanent working capital. Decide if the customer is strategically important to the bank; otherwise, encourage them to refinance or find financing elsewhere.

But do something. If a bank fails to act when first notified of a defined problem, it almost invariably leads to further credit deterioration, increased costs, and losses on the asset. If it has not been done so officially yet, this relationship should be downgraded to "watch" status and transferred to the bank's workout function. In addition, if the main revolver is in default for failure to rest or other improper line usage, issue a default or reservation of rights letter to the borrower. Finally, if there is some equity in the totality of the available assets, a new short-term revolver (or an increase in the current revolver under a new sublimit) may be warranted to get the borrower through the busy season.

The maturity on this short-term deal should be 30-60 days after the end of their busy season and after they collect their receivables. Any available credit enhancements must be picked up via cross-collateralization /cross-default with the primary revolver as well with all other loans held at your bank or collateral that is held free and clear by the borrower. If the line was used to acquire new assets, those assets must be added as collateral, as well as any available guarantees. Concurrently, the main revolver should be modified to recognize the new permanent working capital utilization, which will need to be amortized (as repayment is now from profits turned to cash rather than conversion of current assets to cash). The bank could provide some runway by allowing interest-only payments prior to amortizing the loan (probably after the repayment of the short-term busy season advance). Or the bank could split the revolver into a smaller revolving line based on the new working capital needs and amortize the portion that is permanent working capital or was used for acquisitions. Finally, as part of any agreement/modification, the bank should require the borrower to provide quarterly cash budgets and statements (if they haven't previously done so). If the borrower is not cash flowing or management is not strong enough, you can require them to engage a turnaround consultant. Give them three acceptable firms to choose from and incorporate that into the modification/forbearance agreement. You can also make engaging a turnaround firm a condition if they default further on the deal after the modification or restructure.

If the borrower has no equity in the available assets, then declining the funding increase request may be warranted. This is justified given that they are overleveraged and need to start right-sizing operations and funding the gap. Institute a maturity for the main revolver or, when it matures, require the start of amortization, a principal curtailment, or a switch to another lender.

The Workout Window: From Multifamily to Multi-problems—Handling a Troubled Loan

By JASON ALPERT, CTP, CRC

The RMA Journal, October/November 2024

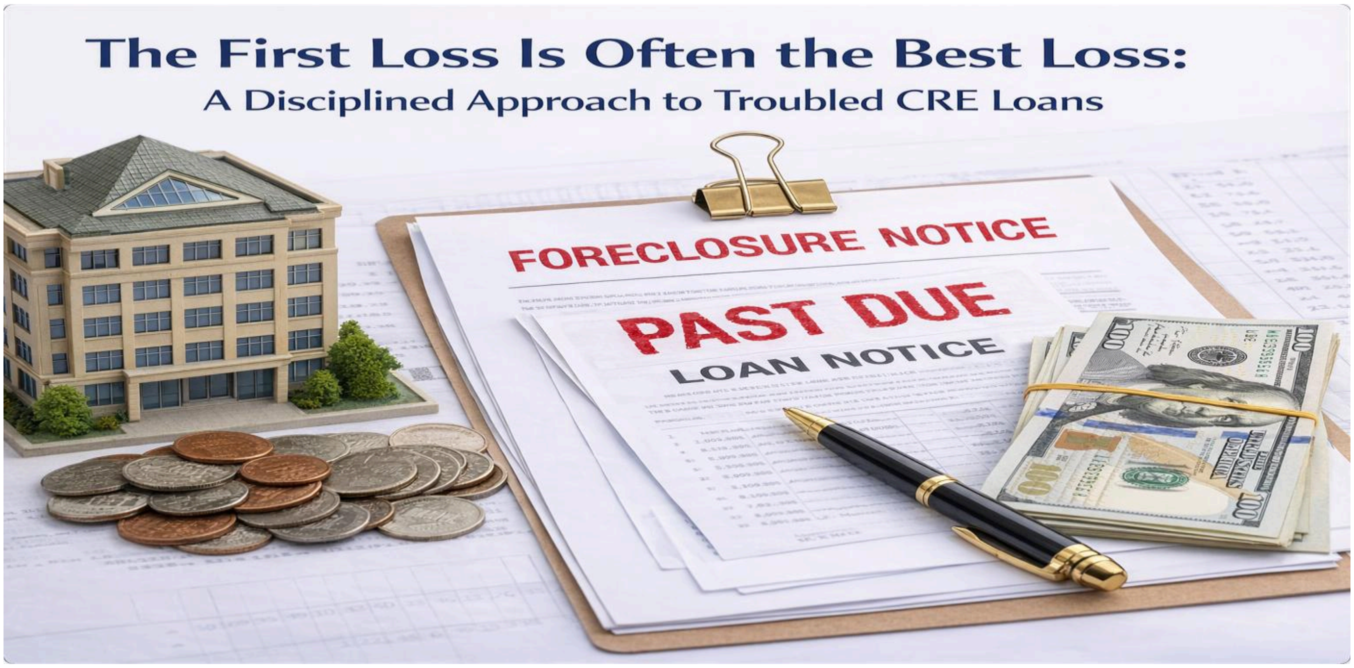
QUESTION: My bank provided a loan to cover the purchase, minor construction, and refurbishment of a multifamily property for $15.885 million. The property is a 60-unit, four-building, two-story garden-style apartment complex that was built 20 years ago. The borrower purchased the property for $14.3 million, with the pro-forma rents of $2,000 per month per unit and a net operating income (NOI) of $885,000, which was underwritten at a 4.15% cap rate ($21.330 million or loan-to-value (LTV) of 74.5% as complete). The loan originated three years ago (2022) and is approaching renewal/maturity. The $1.5 million refurbishment and construction loan was delayed a few months, and the property wasn't formally stabilized until mid-2023. For fiscal year-end 2023, the borrower missed debt service coverage ratio (DSCR) of 1.25x due to lower rents and higher insurance costs. However, we formally waived the DSCR covenant because of the delays in construction and stabilization.

We recently received interim financials for 2024, and the property is still underperforming the pro forma. We are concerned about another DSCR default when we formally test in early 2025 and whether the borrower will be able to right-size the loan in preparation for the maturity event in early 2025. Annualized fiscal year-end 2024 statements show rents are currently less than expected ($1,840 per unit per month), and NOI is down 28% from the pro forma, estimated at $635,000. Our internal appraisal group estimated a current cap rate of 5.25% for the market, resulting in a property value of only $12.1 million (current loan balance is $14.4 million, indicating an LTV of 120%). The loan is being paid as agreed, even though it has a 0.80x DSCR (we believe the $160,000 shortfall is being covered by guarantors, who had combined liquidity of $2 million at closing in 2022). How should we start approaching this credit?

JASON: Given the sub-1x DSCR, the overleveraged nature of the credit, and the pending maturity, I strongly recommend downgrading this credit to watchlist or criticized and transferring it to your workout group. Based on the facts above, it doesn't appear that you have an active default to declare (because you've already waived the previous DSCR covenant), but early intervention with your customer is critical to achieving a win-win solution. To that end, I suggest scheduling a meeting with the customer to discuss the bank's concerns and the upcoming maturity. Consider bringing another banker or credit representative as a second witness, as this conversation may be difficult for the customer. Be sure to take thorough notes, ask thoughtful questions, and listen carefully to the customer's plan for remedying the property's issues. After the meeting, follow up with an email to all attendees, including the minutes of the meeting and action items to be provided to the bank (such as financials, marketing or sale plans, and cooperation on appraisals or other inspections).

Assuming collateral is perfected, and the borrowers or guarantors are cooperative and transparent, the bank may want to retain this customer, especially if they have other assets or services besides this one sub-performing loan. In that case, an A/B/C note restructure may be appropriate, where you bifurcate the loan into two or three separate facilities. The A-note is right-sized to cash flow (with a DSCR of 1.25x) and an LTV that within policy. The B-note and C-note are charged off (all three loans are moved to nonperforming, where interest income is no longer recognized and any payments received are used to pay down the book balance of the loan). After 12 months of performance, the bank may consider upgrading the A-note of the loan to a pass rating and accrual status. The B-note, also known as the "hope note," can be repaid with any excess cash flows or restructured to incentivize the borrower with loan forgiveness. Payments on the B-note accrue interest at a higher percentage, which will be forgiven if the principal is repaid over definite period, and the C-note is fully forgiven if the A- or B-notes are paid off. There are various ways to handle the B- and C-notes.

For illustrative purposes, based on the fact pattern above and assuming the current NOI is stabilized (double-check via third-party appraisal), the A-note may be right-sized to support a 1.25x DSCR at a 6% rate and 25-year amortization, assuming these terms should be as close to market as possible. This would result in an A-note balance of roughly $6.6 million, leaving a $7.8 million balance allocated between the B- and C-notes. I recommend the B-note be right-sized to the value of the collateral, or $5.5 million—the total value of the collateral is $12.1 million, less the A-note of $6.6 million. The remaining $2.3 million is the balance of the C-note. This scenario may seem dire for the bank, but given the tremendous changes in the market over the last three years, both shrinking NOI and the rise in interest and cap rates have crushed value. The goal is to incentivize the borrower or guarantor to retire the A-note and the majority of the B-note, allowing the bank to recover in the next year or so. This is why a net present value (NPV) analysis should be conducted on various restructuring scenarios, based on facts and information from the borrower. Perhaps the A/B/C note restructure is too risky or infeasible, in which case a note sale or discounted payoff may be the best result for the bank. It's important to note that this type of restructure and loan redocumentation is complicated and not suitable for internal documentation. Outside counsel should always be engaged for this type of deal.



The First Loss Is Often the Best Loss: A Disciplined Approach to Troubled CRE Loans

By Jason Alpert, CTP, CRC

Law.com / Daily Business Journal, November 2025

For institutions unaccustomed to navigating turbulent markets, the temptation to delay hard decisions can be strong. Too often, banks default to what insiders call “pretend and extend”—renewing troubled loans in the hope that external factors will improve repayment.

Community and regional banks are facing mounting pressure. Commercial real estate stress, higher capital costs, and increasing regulatory scrutiny are converging at a time when many lenders have not experienced a true credit cycle in nearly two decades. For institutions unaccustomed to navigating turbulent markets, the temptation to delay hard decisions can be strong. Too often, banks default to what insiders call “pretend and extend”—renewing troubled loans in the hope that external factors will improve repayment. It may feel safer in the short term, but the strategy rarely ends well.

The cost of delay can be severe. Extending loans without a credible turnaround plan erodes portfolios, weakens capital, and diminishes shareholder value. In workouts, the first loss is often the best loss. Recognizing a problem early and acting decisively frees up capital, reduces future losses, and allows banks to focus on viable borrowers. I've seen this firsthand. In one case, a regional bank held onto a distressed loan for months, hoping market conditions would improve. Multiple forbearances were granted, reserves were exhausted, and the eventual sale yielded far less than if the bank had acted promptly. Cutting bait early might have meant booking a loss, but it would have preserved shareholder value and capital for stronger opportunities.

Human biases compound the challenge. Ego can prevent credit officers from acknowledging that a loan has become a problem. The sunk-cost fallacy often leads to thinking, “We've already lent $5 million; we can't walk away now.” Relationship pressures, particularly in community and regional banks where ties with borrowers run deep, can cloud judgment. Incentive structures that reward maintaining portfolio optics over addressing real risk exacerbate these tendencies. The result is a portfolio weighed down by decisions driven more by emotion than data. These instincts are natural, but in credit, emotion is expensive.

The antidote is discipline. Every workout should begin with thorough re-underwriting to identify the root causes of the borrower's distress, uncover hidden risks, and assess the credibility of any turnaround plan. With a full understanding of the situation, the bank can determine the best path forward: a structured restructure, temporary relief, or an orderly exit. Regulatory frameworks like CECL (current expected credit loss) give banks more discretion in grading loans than past rules allowed. While that flexibility is helpful, it can tempt bankers to postpone downgrades and losses, putting optics ahead of shareholder value. Discipline ensures capital is allocated efficiently and losses are managed strategically.

A disciplined approach also requires transparency from borrowers. Full financial disclosure and a credible turnaround plan are critical. Relief measures—modified covenants, adjusted interest rates, or temporary payment reductions—can give a viable business the runway it needs to execute a recovery plan. But when a borrower cannot provide sufficient credit enhancements or lacks a credible plan, banks must recognize the loss, downgrade the loan, and reserve the appropriate capital. While this approach may impact short-term earnings, it protects the institution from outsized losses later and preserves shareholder value.

Pretend and extend may defer today's pain, but it guarantees tomorrow's hangover. Delaying recognition of troubled credits often results in a cascade of consequences: depleted reserves, constrained capital, and portfolio drag. Banks that act decisively, even when that means taking a loss early, typically emerge in a stronger position. In practice, first losses are often smaller, more manageable, and can even facilitate creative solutions for borrowers who can realistically recover. Ignoring problems in the hope they will disappear almost never works.

The stakes are high, particularly in CRE portfolios. Many banks are facing rising vacancies, declining rental income, and exposure to loans originated in a booming market that no longer exists. In this environment, timely decision-making is critical. Workouts are not about punishing borrowers; they are about protecting the institution while giving viable businesses a chance to succeed. A structured, disciplined process allows banks to balance these goals effectively, creating outcomes that are both commercially and ethically sound.

In addition to discipline, objectivity is paramount. Decisions must be grounded in financial reality, not emotion or relationship sensitivity. I have witnessed situations where senior bankers refused to sell a loan at a discount for fear of the reaction of the Street, even after the institution had already reserved significant losses. Such hesitation can be costly. Selling early, or recognizing a first loss, releases capital, strengthens the balance sheet, and positions the bank for future growth.

The principles extend beyond individual loans to broader portfolio management. Every decision to restructure or exit a loan sends a signal to the market, to regulators, and to shareholders. Banks that act decisively establish credibility, demonstrate strong risk management, and protect their long-term viability. Conversely, institutions that delay or obfuscate risk can find themselves exposed to cascading losses that erode trust and stability.

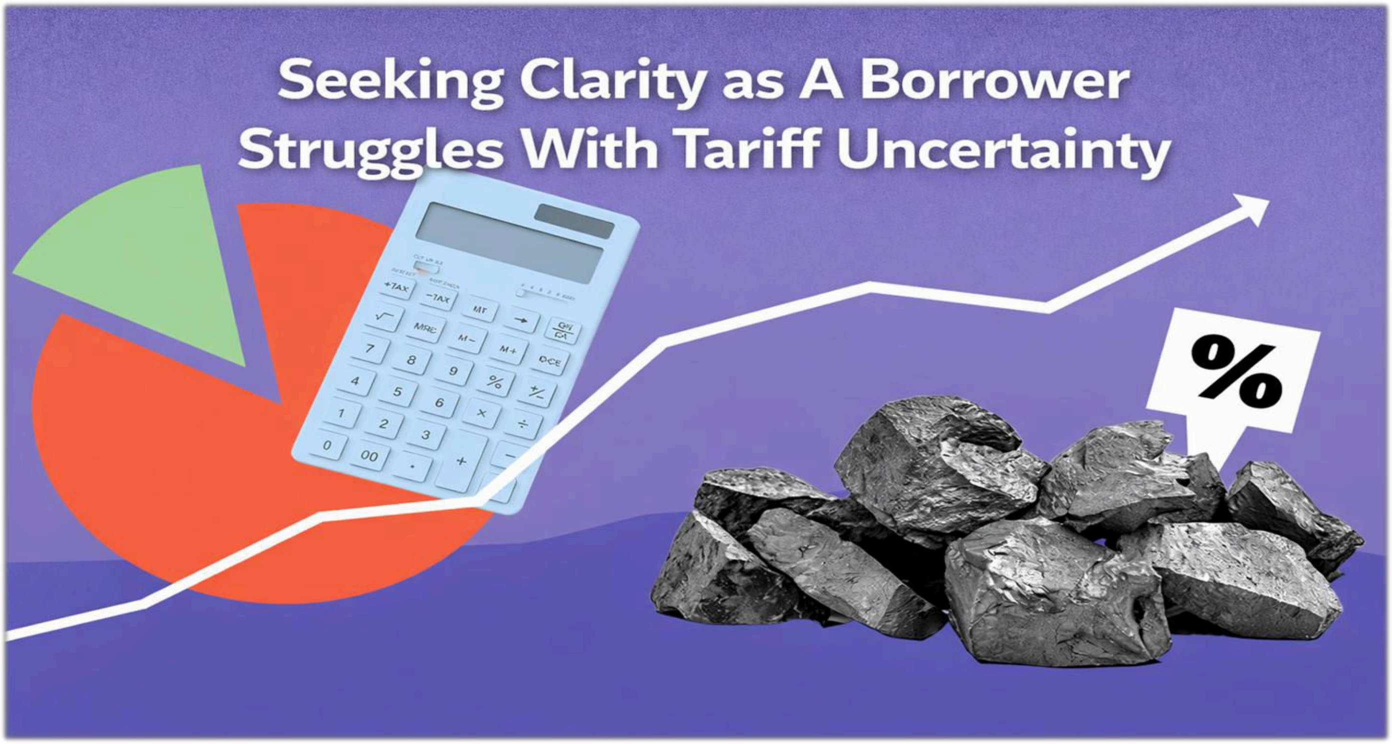
Ultimately, the lesson is simple: in banking, as in life, the first loss is often the best loss. Recognizing it early requires courage, objectivity, and discipline. It means confronting uncomfortable truths about borrower viability, portfolio risk, and market conditions. It means putting shareholder value first, even when doing so may temporarily disrupt relationships or short- term earnings. Those who master this approach not only protect their institutions but also create the conditions for sustainable growth and long-term success.

As the credit cycle turns, banks cannot rely on hope, optimism or delayed decisions to protect value. The tools exist: disciplined workouts, clear analytical frameworks, and transparent borrower engagement. What remains critical is the mindset—prioritizing action over denial, objectivity over emotion, and long-term shareholder protection over short-term comfort. For bankers, embracing the first loss as a strategic tool rather than a failure can be the difference between a manageable portfolio and one that drags down the entire institution.

The market will continue to test banks, and CRE exposure will remain a challenge. Those who act decisively, with discipline and rigor, will navigate the cycle successfully. Those who cling to delay and denial risk repeating mistakes that could have been avoided. Because in the world of troubled credits, the first loss is not a setback - it is often the best decision a bank can make.

Revolving Credit, C&I Stress & Liquidity Risk

Where problems accelerate fastest



The Workout Window: Seeking Clarity as A Borrower Struggles With Tariff Uncertainty
By JASON ALPERT, CTP, CRC
The RMA Journal, June 2025

QUESTION: I have a $50 million revenue B2B customer that manufactures specialty components used by U.S. producers of small consumer products. The company struggled with a significant sales slowdown in 2024 due to weaker consumer demand, which has already strained liquidity and pressured margins (they did manage to pass their fixed-coverage charge ratio, just barely). We currently have a $12 million revolver and a $5 million equipment term loan in place.

Earlier this year, anticipating potential new tariffs (with the proposed 10% universal tariff on imports), they front-loaded raw materials from Southeast Asia and Europe. This move has pushed them into an over-advance on their inventory borrowing base, and they've also stretched payments to key domestic suppliers to manage cash flow. My credit officer is already concerned about the over advance.

To complicate matters further, their smaller B2B customers—many of whom are facing their own end-market weakness—have started stretching payments, which has left about $1 million of their accounts receivable (A/R) now excluded from the borrowing base due to aging over 90 days past due. This has contributed to additional liquidity pressure.

If consumer demand remains weak through the second half of the year, they may not be able to sell through their current inventory at the planned volumes or margins—which would put even more stress on their borrowing base and cash flow position.

What should we be doing now to manage through this increasingly complex situation—both in terms of monitoring key risk signals and proactively working with the borrower—before we face a deeper problem with the revolver, borrowing base, or their supplier and customer relationships?

JASON: Based on the fact pattern laid out, this customer is certainly distressed and should be downgraded to at least "special mention grade," with a concurrent transfer to your bank's workout group. The customer is facing both short-term and long-term issues that must be addressed, and your bank needs to engage proactively.

Short-term: The bank needs to immediately engage with the customer and issue a default letter based on the over advance on the borrowing base. Given that the default letter is just being issued, it may be too early—and the bank may not yet have enough information—to determine whether to keep the facility fully open and allow the borrower to draw it up and down as current assets are converted to cash.

Concurrently with the issuance of the default letter, you should inform the customer that the account is being transferred to workout, and request any missing or supplemental financial information that will help clarify the borrower's current condition.

Long-term: The customer may be facing a potential double whammy—a slowdown in revenue due to reduced consumer demand for their end products, and rising costs of goods sold due to the proposed 10% universal tariff (which affects their raw materials and component parts).

While it is too early to tell whether the consumer pullback and tariff policies will prove long-lasting, the borrower is currently overleveraged and should be taking proactive steps to strengthen their balance sheet and maintain flexibility to survive through a possible recession.

Assuming bank management would like to maintain the relationship, and the borrower remains cooperative in providing current financials and pro formas, the bank should consider offering a short-term forbearance to allow time to assess the situation and craft a longer-term solution.

As part of the forbearance, the borrower should formally acknowledge all defaults and provide waiver of claims/lender liability protections to the bank. The forbearance period should also be used to obtain updated field exams and appraisals of any real estate and other valuable assets supporting the debt.

In addition, the bank should consider requiring the borrower to engage a qualified turnaround consultant who can help stabilize top-line revenue, drive efficiencies on the expense side of the P&L, and improve cash flow through the business. The turnaround consultant should be tasked with preparing a realistic plan and supporting documentation that the bank can use to evaluate potential restructuring of the debt. They additionally can help the customer navigate the unexpected challenges that arise in the current uncertain market.

Many borrowers and lenders are understandably focused on the cost implications of tariffs—but another, even more immediate concern is emerging: the availability of the goods and components borrowers need to operate. Supply Chain Today notes that in addition to driving up costs for importers, tariffs "can disrupt the flow of goods," leading to "delays, stockouts, or longer lead times."

If the bank's loans are not already cross-defaulted or cross-collateralized, the forbearance period is also the time to address this. The bank should also consider seeking any additional credit enhancements or a paydown, particularly if the borrower has an equity sponsor with sufficient wherewithal.

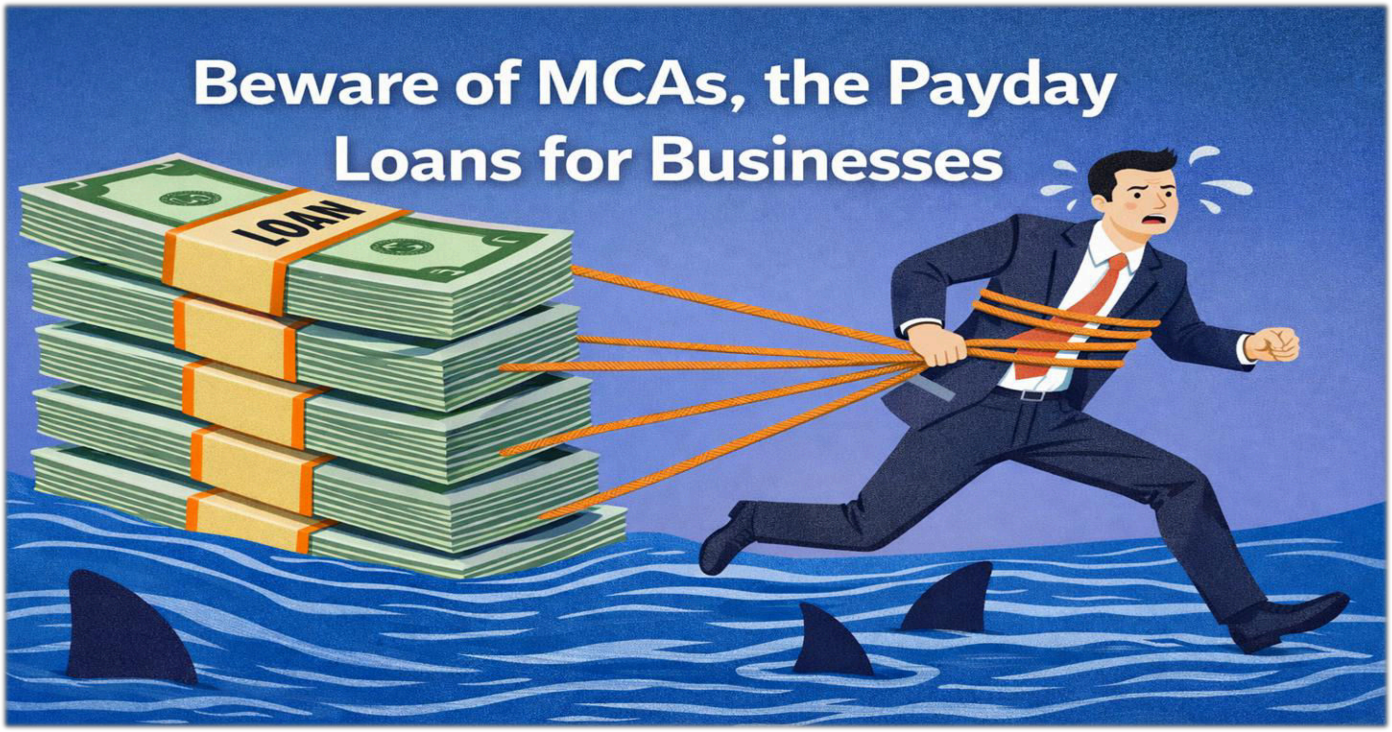
Assuming the turnaround plan demonstrates that the borrower is preserving liquidity and making the necessary adjustments to the business, the bank should consider addressing the over-advanced in the following manner:

Bifurcate the revolving line of credit (RLOC) facility, rightsizing the open revolver to match eligible and lendable working capital assets. If advance rates were too aggressive at origination, now is the time to adjust them to more conservative levels.

Term out the over advance—and any additional amounts exceeding the new collateral base—in a new amortizing facility (typically 5–10 years), structured so that payments are sustainable for the borrower. A good rule of thumb: the longer the amortization, the shorter the forbearance duration. This new term loan should be collateralized with real estate and all bank loans should be cross-collateralized.

As part of the global restructure, implement enhanced financial reporting requirements and performance covenants tied to the turnaround plan. Any new defaults must be promptly addressed and the long-term designation of the credit as a retain/exit customer revisited.

Handled thoughtfully, situations like this can give the bank and borrower a chance to reset the relationship, restructure the debt, and position the company to survive a tougher economic cycle.



The Workout Window: Beware of MCA's, the Payday Loans for Businesses
By JASON ALPERT, CTP, CRC
The RMA Journal, September 2025

QUESTION: A middle-market manufacturer has a $7 million revolver and a $3 million term loan with us. They've recently stacked two merchant cash advances (MCAs) totaling $1.5 million. Payments on those MCAs are hitting their operating account daily, and it's starving their liquidity. The borrower hasn't defaulted yet, but our borrowing base is under pressure, and the company's CFO admitted they turned to MCA financing because we wouldn't increase their line. How should I handle this situation? Do I call a default, force a lockbox, or is there another way to unwind the MCA exposure without pushing them into bankruptcy?

JASON: Yikes — your borrower has put themselves between a rock and a hard place by taking out a hard-money "loan" in the form of an MCA. Before I offer my take, including why I put the word "loan" in scare quotes, here's a quick primer on MCAs for any readers who may not be familiar with them:

While MCAs have technically been around since the 1990s, they exploded in popularity after the Great Recession when banks tightened credit and fintech players flooded the small business market with promises of fast cash and no-questions-asked approvals. They're marketed as liquidity lifelines, but make no mistake: MCAs are payday loans for businesses. And just like payday loans, they're quick, expensive, and can be devastating.

Here's why. MCAs live in a legalistic gray zone. They're structured not as loans, but as "purchases of future receivables." That legal fiction lets MCA providers avoid usury caps and disclosure rules.

But the economics tell the real story. Instead of an interest rate, MCAs charge a "factor rate."

For example, a 1.3 factor on a $1 million advance means $1.3 million must be repaid — regardless of how quickly it's collected. Translate that into APR and you're talking 60% to 150% in most cases, with extreme examples having effective rates north of 200%. Combine that with daily or weekly ACH debits, and liquidity bleeds out of the business faster than management can plug the hole.

A business that relies on MCAs can face a triple whammy:

1. Sky-high borrowing costs
2. Operating accounts drained by constant debits
3. Clouded collateral from Uniform Commercial Code (UCC) filings

More on No. 3: MCA documents look and act a lot like loan agreements by including personal guarantees, confessions of judgment, and UCC-1's against receivables and deposit accounts. I've seen situations where the UCC-1 isn't even filed by the MCA provider itself but by a third-party servicer, further muddying title. That slows down refinancings, complicates note sales, and jams up any transaction where clean lien searches matter. Attorneys I've talked with, on both the creditor and debtor side, agree that the use of MCAs is a flashing red light, more like a fire alarm than a red flag, when it comes to borrower distress.

Back to your current challenge: Now that you know the borrower has a significant $1.5 million MCA, the bank needs to take immediate action. Step one: Downgrade the loan and move it into workout. The presence of an MCA is very likely an event of default under the bank's loan documents that require "no additional indebtedness" and "no additional liens." That means default letters need to go out quickly to protect the bank's rights. Don't sit on these defaults. Time is not your friend when an MCA is involved.

Step two: Engage with the borrower immediately. Pin down what led to the cash crunch, require updated financials, and get their plan to resolve the default. The CFO has already admitted they turned to MCA financing because the bank declined a line increase. That admission cuts both ways. The bank needs to ensure its decline was properly documented to avoid lender liability. It should also confirm whether the borrower was transparent about what they would do if the bank said no. If the manufacturer represented that they'd pursue a conventional refinance but instead back doored into MCA financing, that misrepresentation needs to be documented and the bank should consider if it reflects a character issue with management/ownership.

Assuming no lender liability issues and no deliberate misrepresentation, the bank still has to chart a path forward. A forbearance agreement may make sense, giving the borrower breathing room to refinance, sell assets, or bring in equity to clear the MCA. Any forbearance must include consideration to the bank including increased financial reporting, credit enhancements, tighter covenants, and, most importantly, cash dominion. Re-establish control over operating accounts and make sure bank debt gets paid before the MCA does. In more extreme situations, if collateral and cash flow support it, the bank might even consider a protective advance, increasing its exposure, to retire the MCA before it takes down the entire business. If none of those options are feasible, a note sale might be the most efficient exit.

This is also a wake-up call to fine-tune your MCA radar before other credits get this far. The tell-tale signs are there if you look closely: a sudden large deposit followed by daily or weekly debits to the same entity, overdraft and nonsufficient funds activity spiking, a balance sheet with mysterious short-term liabilities, or borrowers who suddenly get cagey about providing full account statements. Spotting these patterns early can mean the difference between a manageable workout and a full-blown collapse.

And don't underestimate the educational role bankers can play with clients. Borrowers often turn to MCAs out of desperation or ignorance. Proactively warning them about the dangers, the crushing costs, the loss of liquidity, and the effect on bank relationships can prevent problems before they start. Many small business owners think they're solving a cash crunch when in reality they're heading down a much-worse path.

Left unchecked, they don't just damage the borrower, they impair collateral, gum up lien searches, and drag the bank into a messy, time-consuming fight for repayment. The sooner you intervene, the better your odds of helping the borrower escape an MCA's clutches and preserving value for the bank.

The Workout Window: A Lender Who Inherited a Troubled Loan Asks, 'Should We Stay or Should We Go?'

By JASON ALPERT, CTP, CRC

The RMA Journal, December 2025

QUESTION: Jason, my bank, a large regional, recently completed the acquisition of a smaller community institution and is in the process of reviewing and transitioning legacy credits to our own credit and monitoring standards.

One inherited relationship is a lower middle market manufacturing company with a $5.25 million, unmonitored revolving line of credit. The borrower produces precision components for the industrial sector (in a mature industry) and has operated for several decades (albeit the last five years or so with flat revenue and near breakeven profitability). Under the prior bank, the facility was loosely structured with minimal reporting, occasional temporary over-advances, and covenant waivers granted informally.

As part of the post-merger integration, our bank plans to convert the relationship to a monitored borrowing base line, bring it into compliance with current credit policy, and upgrade the credit from watchlist grade to "pass" once compliant.

During the onboarding review, the borrower requested a change in terms to accommodate extended payment cycles from key customers. The modification makes commercial sense and the borrower appears cooperative and transparent. However, granting the request would create an over-advance and the customer does not have the free and clear collateral to pledge.

Cash flow is too tight to amortize the over-advance in any meaningful way. Finally, the bank's leadership team is lukewarm on the industry and relationship given the historical financials (borderline pass grade) and lack of ancillary treasury or other products with the borrower and its principals.

The borrower's liquidity is tight, though collateral quality (A/R and inventory) appears generally sound. The company also owns the industrial/warehouse facility it operates from, but this property is held in a separate single-asset entity (SAE), with the mortgage financed by another bank. There may be some equity in the property, but the amount and accessibility are uncertain. How should we approach the borrower's request for the change in terms and the potential over-advance?

JASON: Given the borrower's transparency and willingness to cooperate, my take is that the bank continue evaluating the requested change in terms and simultaneously pursue a restructure to bring this loan into compliance with the bank's policy. However, since the customer is over-advanced based on typical advance rates, they are inherently overleveraged, especially since operations are flatlining. Their apparent limited opportunity to grow topline revenue in their mature industry and generate cash flow growth hinders their ability to grow out of their leverage position.

I would recommend running dual paths:

- First, restructure the facility to give the borrower breathing room to continue servicing the debt.

- Second, encourage the borrower to consider capital alternatives to fix their balance sheet problem.

While you mentioned that bank management is tepid on this relationship, would they reconsider if the borrower found additional equity to right-size the loan and fund operational and efficiency initiatives to restore profitability?

If an equity solution isn't available or if your leadership would rather just have the relationship resolved (perhaps due to purchase accounting benefits that have the loan marked less than what is outstanding, allowing for a recovery in the event the loan is paid off) then looking at a refinancing solution (either with another bank, credit union, or private lender) makes a lot of sense.

But first things first: In my view the loan needs to be bifurcated, and the borrower should have the ability to continue operating with a working capital line and a permanent working capital term loan. Assuming that the bank has received all current and historical financials and any third-party reports, it should have an idea of the appropriate size of the working capital line the borrower can afford. The remaining balance (or the over-advance) would be a permanent working capital loan that would have a different rate and would ideally be amortizing.

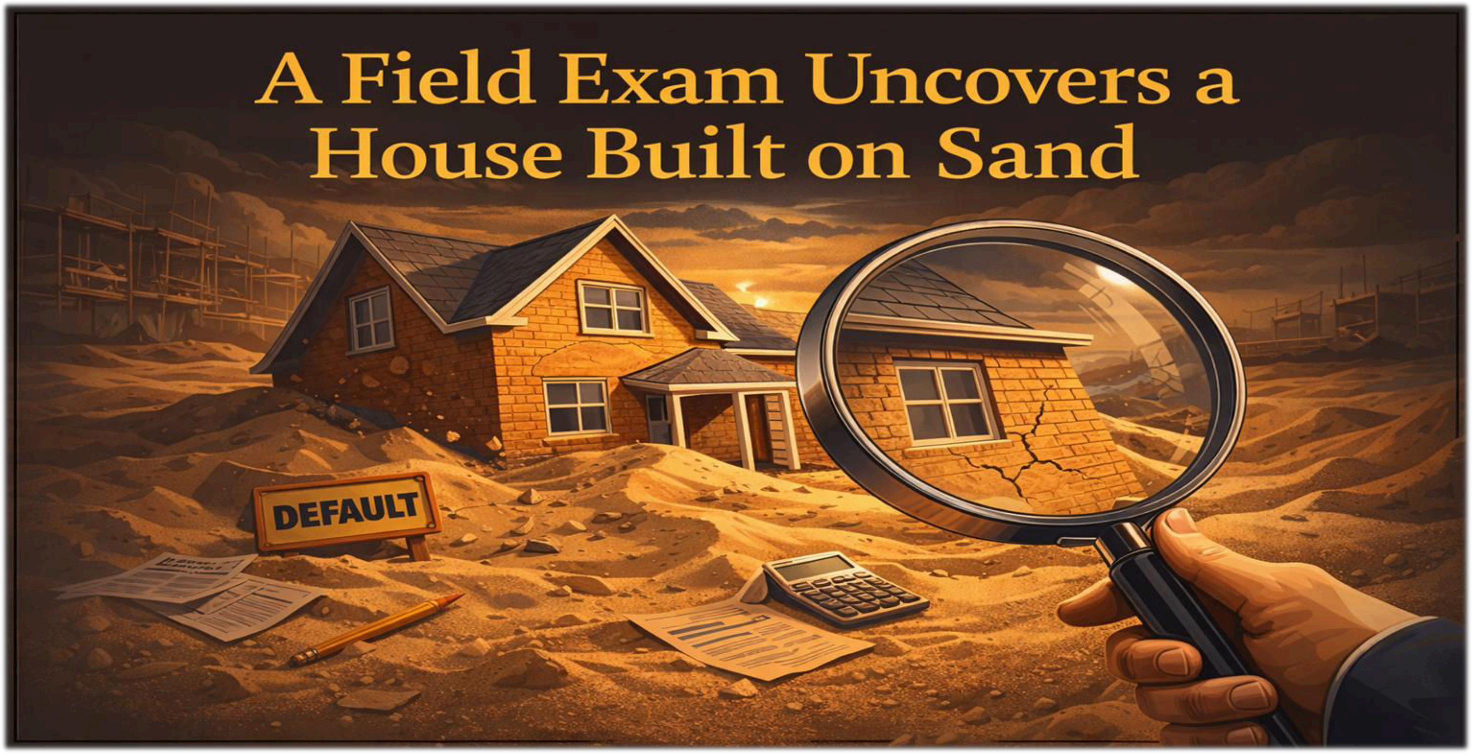
The reason for two loans is that each has a different repayment source and thus a different risk profile. (The working capital loan is repaid by current assets converted to cash and the permanent working capital loan is repaid by profits turned to cash). Both loans would be collateralized by the same assets; however, the permanent working capital loan will be under-secured because the value of the working capital assets is insufficient.

This lack of collateral could be addressed by requesting the borrower (through their SAE) provide a second mortgage on the owner-occupied real estate. However, the bank should be careful of requiring that pledge, especially since, most likely, the other bank's mortgage documents do not allow for additional liens without approval. (The borrower would have to approach its other lender for approval.) If the borrower is amenable to that structure (and it receives the other lender's approval) that may sway bank management's decision to retain the loan, especially if the borrower has a plan to return to a stable cash flow and an ability to repay (with appropriate amortization or principal curtailments) the permanent capital loan.

Be sure to keep the restructured loans on a tight leash (a duration of less than 12 months) with adequate reporting and covenants to stay on top of the borrower's turnaround plan. (You may also want to consider the requirement of a turnaround consultant.)

However, if the borrower can't or won't pledge the additional collateral—and a turnaround plan to have the borrower pay down the over-advance loan is too long of a putt—then it's time to encourage or require the borrower to obtain alternative financing concurrently with the restructure. In today's market there are a wide range of sophisticated and professional private credit groups that could refinance the relationship and restructure it to align with the appropriate capital stack for the customer. If the customer doesn't have the expertise or Rolodex of private lenders to call, the bank could provide a few recommendations to get the ball rolling and the deal on its way out of the bank.

Whether through a restructured path or an orderly exit, maintaining control of the timeline and terms is key. As with any inherited credit, discipline and creativity must be balanced, especially when legacy goodwill collides with current policy.



The Workout Window: A Field Exam Uncovers a House Built on Sand
By JASON ALPERT, CTP, CRC
The RMA Journal, January 2026

QUESTION: I manage a commercial portfolio that includes a sub-$10 million asset-based revolver to a manufacturer of consumer durable goods whose sales are closely tied to new residential construction. The facility is secured by a borrowing base consisting of eligible accounts receivable and inventory. At origination, the collateral mix and advance rates were considered appropriate, and the borrower had historically complied with reporting requirements.

As new home construction slowed, the borrower's operating performance deteriorated. Sales declined, margins tightened, and liquidity became increasingly constrained. The borrower relied more heavily on the revolver to fund working capital, but borrowing base certificates continued to show availability.

A recent field exam changed our view of the credit. The field auditor identified multiple accounting and reporting issues, including ledger entries that did not reconcile and borrowing base calculations that could not be adequately explained by management. The exam ultimately concluded that the borrower had incorrectly calculated the borrowing base, and that the errors had been masked in prior submissions to the bank.

The audit report cited weaknesses in the borrower's books and records, internal controls, and borrowing base methodology. Based on these findings, we now have material concerns regarding the reliability of the financial statements and the accuracy of historical borrowing base reporting.

The borrower is currently out of borrowing base compliance and materially over-advanced, with no meaningful liquidity to cure the deficiency. We have already taken all available additional collateral outside of the original borrowing base in an effort to support the outstanding exposure.

Overdrafts have begun showing up in the operating accounts as the borrower runs out of working capital.

We are now preparing a default and over-advance notice and are in process of transferring the relationship to workout.

To sum it up, we are seeing continued borrowing base noncompliance, limited liquidity to cure the deficiency, and erosion of confidence in the accuracy of financial reporting and borrowing base calculations. Given the fact that all readily available collateral has already been taken, how would you prioritize next steps to protect the bank's position, evaluate borrower credibility and viability, and determine whether there is a realistic path forward versus an early shift in focus toward recovery?

JASON: I agree that this credit needs to be downgraded and transferred to workout. Given the apparent operational and financial reporting deficiencies, the bank will need to immediately issue a formalized default letter for the over-advance (and any other defaults) and start taking control of the situation. The bank will move from relationship management posture to a risk containment position. This is especially critical with C&I loans secured by working capital assets, given that "soft" collateral is subject to leakage if not outright evaporation as liquidity evaporates from the business. The bank's key objectives need to focus on (i) preventing further collateral erosion and limiting additional exposure (via additional credit exposure or through any lender liability actions; (ii) obtaining visibility of the company's liquidity position and encouraging the borrower to pursue actions that preserve it; (iii) establishing a reliable baseline of financial reporting; and (iv) preserve optionality while the bank determines the best resolution strategy for the asset.

My recommendation would be the following steps to accomplish the bank's objectives with this asset at this initial default moment:

1. Prepare a formalized default letter in coordination with bank counsel (internal or external-if already assigned).

2. Concurrently, the bank should notify the borrower (and any guarantors) of the impending default and request a meeting with the customer to discuss the situation and next steps. Also, request any/all information that needs to be obtained to get a sense of the business results and operations. While the financial reports are potentially unreliable, whatever the borrower can provide is somewhat helpful, although taken with a large grain of salt.

3. At the meeting with the borrower, introduce the new workout banker, who can discuss the workout process and goals as well as establish the new working relationship with the borrower (risk containment). Walk through all issues outlined in the audit/field exams as well as ask all relevant questions to fully understand the nature of the problem(s). Note: most initial workout transfer calls are difficult given the change in relationship nature, so be sure to have two bank reps at the meeting, take very good minutes of the meeting, and email all parties that attended the meeting to establish a "transcript" of the interactions between the parties.

4. If the borrowers are amenable to cooperating with the bank while the workout process is

ongoing, consider a short-term forbearance with the customer to delay acting on the default (a benefit to the customer) and obtain initial strategic goals of the bank. The forbearance is not an endorsement of the borrower's viability, rather it is a tool to buy time and impose structure on the process. Given the reporting issues and the lack of controls at the borrower, the bank should require the borrower to engage a third-party turnaround consultant. Give the borrower a list of qualified consultants who are acceptable to the bank

5. The consultant will be able to work hand-in-glove with customer to institute operating controls, preserve liquidity, identify and implement operational efficiencies, and remediate the financial reporting problems and prepare new managerial reports to guide the customer through their turnaround (i.e., a 13-week cash budget and other reports).

6. The forbearance should also identify and address any other requirements of the bank—such as collateral perfection documents, landlord lien waivers, more frequent reporting or audits, enhanced dominion of cash, changes in exposure, or other services such as ACH exposure and credit cards. Most importantly, the forbearance agreement must contain a "Waiver of Claims and Defenses." Such a paragraph removes any potential lender liability issues that might be brought up by the customer in any adversarial proceedings.

Other terms of the forbearance such as any payment relief, interest rate increases/decreases, deferral of costs, and duration/term of the agreement would be negotiated and subject to the bank's risk appetite. However, the bank's willingness to entertain some of the above terms might be a challenge, especially any deferrals or payment relief until more accurate financial reporting is obtained. Nevertheless, the default deferral should give the customer adequate time to start the turnaround process (60 to 90 days), which should allow them time to start the process and the bank time to make an informed decision of its overall strategy.

Finally, the bank should keep its options open throughout the turnaround process. Early on in the workout process there are a lot of unknowns; however, if the customer's financial reporting failures were a deliberate attempt to obfuscate the true financial condition of the business, the relationship should be treated as an exit relationship because the customer broke their trust with the bank. If the reporting problems were the result of an honest managerial problem (inadequate employees, lack of sophistication, etc.), then the bank may want to retain the relationship, assuming those problems are fixed for good.

If an exit posture is assumed by the bank, the message that the borrower should seek alternative financing should be delivered as soon as possible. Getting the customer in a refinancing mindset earlier is usually better—unless there are identifiable strategic reasons to stay silent, such as the need to obtain documentation or collateral perfection as well as executing a document with the "Waiver of Claims" language in it). If the customer isn't bankable (which given above, they probably wouldn't be), then other solutions such as private credit or private equity should be introduced. If the balance sheet is redeemable, a private credit solution would probably be the best, although it would probably require both a senior secured lender for the primary revolver and a mezzanine slug of capital to plug the over-advance. However, if the balance sheet is too far broken (bordering insolvency), then an equity infusion or sale might be the only solution short of bankruptcy or other alternative strategies. There are a number of private lenders and equity providers that have the risk tolerance to invest in the company and provide the bank a resolution of the loan. The turnaround consultant would also be a resource to assist in that process as well.

Exit Strategies, Legal Tools & Capital Alternatives

Knowing when – and how -- to get out

Note Sales: Achieving a Win-Win

By CAM CHILDS & JASON ALPERT, CTP, CRC

The RMA Journal, August 2022

IN COMMERCIAL BANKING, the death of a lending relationship occurs when an adverse change in the borrower's risk profile leads the bank to exit the credit.

When this happens, bank officers often feel depressed and resentful. Besides the loss of principal, the potential interest income, and valuable time, the projected collection expenses, including legal costs, collateral protection costs (advanced taxes and insurance), and reporting costs (appraisals and environmental reports)—can lead to feelings of despair. However, the banker need not despair. There are alternatives beyond litigation and liquidation that can be used to re- solve criticized credits. One of them is note sales, transactions in which the bank sells its legal interest in the troubled debt to a third party. Note sales can provide the bank with a way to maximize recovery opportunities. And, in some instances, note sales can be a welcome change for the borrower as well. As with any transaction, though, there are inherent risks that need to be fully understood and mitigated prior to closing the agreement. Pricing, timing, and, most importantly, reputational risks must be addressed and fully understood if the bank is to achieve optimal and permanent resolution. But when conducted between a diligent, transparent bank and a reputable, sufficiently capitalized buyer, note sales can provide a mutually beneficial result for both parties. It's worth noting that two experienced parties can conduct a note sale from start to finish in 30 to 45 days.

During the depths of the Great Recession, panicked (and often illiquid) lenders and unscrupulous note buyers created market conditions that left lenders with limited faith in the note-sale resolution strategy. Vulture funds would often inundate banks with prices well below the intrinsic value of the asset or re-trade on the negotiated price at the closing table. In addition, unqualified buyers would negotiate a price but then fail to close due to lack of sufficient capital. When note sales are conducted using a deliberate and systematic approach, a bank can achieve the optimal resolution to the distressed loan, limiting costs, reducing required reserves, and ultimately benefiting the bank's shareholders.

Fortunately, the days of the speculative note buyer have been largely replaced by sophisticated, specialized, and well-capitalized funds that understand the risks of the asset and, more importantly, operate in a way that limits potential reputational and tail-end risk to the bank following closing. Private equity and other debt funds, both large and small, have amassed capital to buy distressed assets from banks and originate bridge loans to marginal borrowers. In fact, today's economic conditions provide bankers with a large market in which to seek potential buyers, including specialized funds, real estate operators, and the local one-off investor.

The process of navigating potential buyers and selecting, negotiating, and closing note sales can be fraught with risk and uncertainty. But when note sales are conducted using a deliberate and systematic approach, a bank can achieve the optimal resolution to the distressed loan, limiting costs, reducing required reserves, and ultimately benefiting the bank's shareholders.

Selection and Due Diligence

The primary step in the process is to determine which asset qualifies as a potential note-sale candidate. First and foremost, the bank must determine that the asset it intends to sell no longer represents a desired client. For individual relationships, there are many reasons to sell a note, including, but not limited to, the following:

- Problems with repayment sources or collateral.
- Bankruptcy or other credit issues.
- Irreconcilable differences with management or ownership.
- A desire to exit the borrower's industry.

Likewise, merger and acquisition activity, capital constraints, or concentration limits may drive upper management to market a pool of assets.

Whatever the impetus for the note sale, the bank must understand that it will result in a permanent loss of future business opportunities with the borrower. Assuming the bank is content with that outcome, then the loan officer must determine the attendant risk tolerances and transaction goals, such as reducing nonaccrual balances, recovering charge-off losses, limiting litigation costs and exposure, exiting the borrower's industry, or avoiding foreclosure and ownership of the collateral.

The next step is to determine if the note is marketable to buyers. The bank must authenticate that it has all the original loan documentation (or at least copies), confirm the collateral (through appraisals, environmental reports, and title work), analyze recent financial in- formation, and determine if any known claims or other issues would need to be disclosed to the purchaser.

Fresh title, UCC, and lien searches can reveal issues with the loan early in the process and streamline due diligence later. Producing a brief summary with key terms, background, collateral description, and reason for the loan sale can also be helpful both internally and externally. Finally, the loan officer must work with bank management to ensure there is an appetite to sell the loan and begin the process of managing price expectations within the bank.

Having made the decision to sell the note, the bank must then determine which firms to seek out as bidders. While this process can vary across institutions, ranging from very formal requests with set bid dates to informal one-off bids, the bank should be confident that the bidders are reputable and have adequate capital to close. The next step is to conduct thorough due diligence on each buyer, including a comprehensive background check and a public records search to ensure there is no record of fraud, unfair dealing, or other unscrupulous behavior by the firm or its principals. It is also appropriate to ask the buyer for professional references.

Furthermore, in order to ensure the right buyers, the bank should understand each bidder's deal-size limit, collateral preference, performance preference, and geographic footprint. Prequalifying a buyer will save time for both parties, as well as protect sensitive customer information from buyers that would not fit the opportunity.

The bank may also inquire about the buyer's ultimate strategy with respect to the loan. For instance, the profile for those purchasers that want ultimate control of the collateral (foreclosure of real estate) are different from those buyers seeking a yield play (purchase the debt at a discount, restructure, and earn the higher effective interest yield). Buyers that fit into the former category are more interested in loans that are in default, or have pending defaults, in order to start collection actions. Meanwhile, the latter group will be more interested in the borrower's credit profile and the loan's underlying interest rate, amortization, and maturity date. Within the note-purchase industry, there are buyers that fill many niches (for example, those focusing on environmentally compromised assets or assets in litigation or bankruptcy).

Once the bank has determined the right buyer profile for the loan, it can intelligently and discreetly solicit bids. When starting the process in earnest, it is important that the bank share the appropriate amount of information necessary for the buyer to make a confident and fair purchase bid. The bank's counsel should generate a confidentiality agreement to be executed before any client information is shared.

While all manner of information can be shared, it should include items that represent the facts of the credit: loan documentation, borrower and guarantor financials, loan payment history, appraisals and environmental reports, title work, and formal documentation or notices with respect to defaults and litigation. It is generally inappropriate to provide internal documentation, financial spreads or credit memos, and internal bank e- mails or correspondence. If in doubt, the bank should seek legal counsel.

Given the nature of the disclosures, it is important, even with the protection of a confidentiality agreement, to share information judiciously and only with those buyers who have cleared the due- diligence checks and have a history of closing. Even if the loan is designated to sell, the bank has a duty to protect client information by limiting it only to those with a legitimate business purpose.

Pricing and Negotiation

Despite what appear to be diametrically opposed aims of the bank and the note buyer, the process of determining the note's pricing involves essentially the same analysis as when deriving the as- set's net present value. While the bank can conduct a competitive bid process to determine the price (as with bulk sales, especially), the intrinsic value of the as- set remains the discount expectations of future cash flow. The buyer calculates the net present value of several possible resolution scenarios and arrives at a single price to offer for the credit, based on the inherent risk and expected return.

In order to have a realistic expectation of the note's value, the bank should conduct a net present value analysis to determine the fair price of the asset, as well as the best resolution strategy to maximize recovery for the bank's shareholders. Often, due to the time value of money and the inherent risk of the under- lying credit, the note is sold at a discount relative to face value and the underlying gross collateral value.

While an entire article could be writ- ten on financial modeling and pricing, a net present value analysis can be conducted with a simple Excel® spreadsheet and the loan officer's knowledge of the credit's various aspects. When building the model and comparing various resolution strategies, such as foreclosure, debt restructure, discounted payoff, and note sale, the banker should consider the following:

1. The expected cash inflows and outflows.'

2. The timing of those cash flows.

3. The applied discount rate (at least as estimated based on the loan loss reserves required to carry the book value of the asset on the bank's balance sheet).

With respect to the cash inflows, the banker should consider the debt service payments (if payments are likely to occur in the future) and the ultimate liquidation of the collateral (based on the appraisal), as well as any guarantor cash infusions or settlements (as to be reasonably expected from personal financial statements and demonstrated willingness). As for out- flows, the loan officer should include reasonable estimates of attorneys' fees, management or receiver fees, appraisal/ environmental costs, taxes, insurance, repairs and maintenance, and other out-of-pocket expenses incurred during the collection or resolution of the loan.

In estimating these expenses, the loan officer can supplement judgment by using actual expenses from assets resolved in the past. Forecasting the timing of these cash flows (monthly basis works best) and discounting back to present value will give the banker a good understanding of the best option for resolving the asset.

Since the buyer conducts a similar analysis, the key to arriving at a mutually agreed upon sales price is an open and honest negotiation to reconcile the bid/ask spread. While both parties will be looking for the most optimal price, transparent discussions as to each party's valuation of the underlying collateral and projection of the asset's cash flows can help bridge significant pricing differences.

Not all negotiations will result in an agreement on price, however. For instance, the buyer may not concur with the valuation of the collateral, or the bank may decide it would be best served by restructuring the debt with the borrower. Nevertheless, even if a sale is not successful, the net present value exercise will at least give the banker a good understanding of the resolution strategies and provide a basis for the go-forward strategy on the asset.

Occasionally, the loan officer will be unable to gain approval to sell at a market-clearing price because of internal marks (the bank's higher intrinsic value of the asset). If the loan does not trade, it is appropriate to follow up with the note buyer in six to 12 months and ask for a fresh price based on the updated facts on the loan, particularly if the bank has taken further charges to book balance and has made only incremental progress in resolving the asset.

Closing

Once buyer and seller have agreed on a price, the next step is to finalize the due diligence and move toward a closing. The bank's primary focus should be on drafting the loan sale agreement and the closing documents.

Some banks may have these documents already drafted. But if the lender does not have a formalized process, it should seek legal counsel experienced in drafting and closing note-sale trans- actions. The attorney handling collection efforts with respect to the loan is often capable of drafting the contract. However, it is important to confirm the attorney's experience in drafting such agreements and closing similar transactions.

The primary goal of the document is to have the bank sell its interests without any ongoing liability, while also balancing the buyer's need to obtain the necessary representations and warranties that it is buying what it bargained for. At a minimum, the bank should expect to represent the following:

- Ownership of the loan and the right to transact.
- Completeness, authenticity, and ac- curacy of the loan documentation provided for the buyer's review.
- Accuracy of the loan balances and payment history.

Additionally, during the time when le- gal counsel or the documentation group is preparing the closing documents, the bank should be verifying the original documentation and the accuracy of the loan accounting.

Finally, the bank needs to communicate internally the decision to sell the note, if this has not already been done. Notification must be given to any internal group or line of business that services the borrower, for example, treasury, derivatives, or community relations. When the transaction closes and the funds are received, the bank needs to prepare correspondence to the borrower notifying it of the sale and identifying the new lender.

Conclusion

No bank ever intends to extend credit only to have to sell its interests, especially at a discount. And while the permanency of the note sale can take on the air of a funeral, the transaction, if sourced, analyzed, and negotiated properly, can bring benefits to all parties. The bank eliminates the ongoing collection and drag on earnings that can result from a substandard credit and focus on growing new business with profitable clients. For its part, the buyer obtains an asset that allows it to achieve its return-on-investment objectives. Even borrowers can benefit if the transaction allows them to eventually deleverage or to find a more flexible and risk-tolerant lender free of the constrictions of regulated depository institutions.

This efficient reallocation of resources allows each party to focus on its respective strengths, ultimately benefiting everyone's shareholders. Like a phoenix rising from the ashes, the note-sale trans- action can transform a dead asset into one that maximizes the return potential for all parties, thus turning a funeral into a celebration.

A Banker’s Guide to the Bankruptcy Code’s New Subchapter V
By CHRISTIAN GEGORGE & JASON ALPERT, CTP, CRC
The RMA Journal, August 2023

MOST BANKERS UNDERSTAND the major chapters of the bankruptcy code: Chapter 7 (liquidation) and Chapter 11 (reorganization). But what about the relatively new Subchapter V form of bankruptcy?

Enacted just before the COVID-19 pandemic under the Small Business Reorganization Act (SBRA), it provides qualified small business debtors a less expensive, more streamlined process to reorganize debts. While this benefits an important part of the U.S. economy—small businesses comprise 44% of economic activity, create two-thirds of net new jobs, and contribute to American innovation and competitiveness—it poses challenges for banks. By failing to prepare for a possible influx of Subchapter V filings, lenders could incur larger loan losses, higher servicing costs on bankruptcy loans, and higher reserves on their balance sheets. That would especially be the case in a recession when there are more bankruptcy filings by small businesses and other customers. Because they are less capitalized and more concentrated with respect to revenue streams, geography, and management than larger firms, small businesses can be disproportionately affected by downturns and disruption. We saw this a few years ago with the pandemic and related supply chain problems and related supply chain problems and labor shortage, and we are seeing it now with inflation. It is anticipated that these types of filings will become more prevalent than Chapter 11 filings. This article explains how banks can mitigate their potential risks by proactively understanding Subchapter V and creating systems and processes to work through its nuances.

Eligibility

Let's first discuss who is eligible to file under the SBRA. Originally, any per- son or entity engaged in commercial or business activities that had aggregate noncontingent liquidated debt, both unsecured and secured, no higher than $2,725,625 could—as long as at least half of that debt arose from the debtor's commercial or business activities. However, Congress, which originally passed the law in 2019, increased the debt ceiling to $7.5 million through the 2020 CARES Act—and has extended the sunsetting of that modified amount once. While not entirely clear at this point, many predict the $7.5 million amount will become permanent law.

Eligibility is quite broad and could cover personal guarantors on commercial loans, as long as their debts originate from business operations. This is important because the SBRA could effectively render an unsecured personal guarantee on a commercial loan relatively worthless. These particular personal guarantors could attempt to modify the treatment of their home loans if they qualify for a Subchapter V.

There are specific exclusions from who or what may qualify as a small- business debtor. Public entities do not qualify, nor do individuals or entities that classify as single-asset real estate (SARE) entities. A SARE debtor generates substantially all gross income from a single property or project. Examples include shopping center operators or companies managing office buildings. Most hotels are not considered SARE entities because they tend to generate additional income from gift shops, valet parking, restaurants, or other ancillary activities. Of course, a determination of this is highly fact- specific. Lenders should consult with an attorney for a thorough analysis of individual situations.

How Subchapter V Is Different

Subchapter V reorganizations are significantly different from typical Chapter 11 bankruptcies. First, only the debtor may file a plan in an SBRA case. The code eliminates a creditor's ability to file a competing plan. That eliminates a tool that, in a Chapter 11 case, allows a creditor to propose plan treatment that may be more attractive than a debtor's plan, and to obtain confirmation despite the objection of the debtor.

Second, a debtor under Subchapter V may obtain confirmation of a plan without any consenting creditors, which leaves creditors reliant on the law and the judge to prevent confirmation. Typically, a Chapter 11 debtor needs at least one class of accepting creditors to confirm a plan. In an SBRA case, a debtor can literally confirm a plan despite the objections of every creditor. As a corollary to this significant difference, the absolute priority rule does not apply in a Subchapter V case. The absolute priority rule protects Chapter 11 creditors by requiring the claims of a dissenting class of creditors to be paid in full before any class of creditors junior to the dissenting class receives any value for its claim. Under the SBRA, this protection does not exist. As a result, the equity owners of a debtor could retain their interest in a debtor company—in other words, their equity retains monetary value—despite the fact that the dissenting unsecured creditors do not get paid one penny.

Instead of having to comply with the absolute priority rule, an SBRA bankruptcy debtor must satisfy a ‘fair and equitable" test as to unsecured creditors, which the debtor can satisfy in one of two alternative ways. First, it could pay its “disposable income” to the standing trustee over a three-to-five- year period. Notably, the definition of ‘disposable income” is quite narrow, so creditors could get paid very little on their unsecured claims. Specifically, “disposable income” in this application means income received by the debtor that is not reasonably necessary to (1) maintain and support the debtor or a dependent; (2) satisfy domestic support obligations that become first payable post-petition; or (3) ensure the continuation, preservation, or operation of a business. Because the SBRA is relatively new, there is very little case law that clarifies how courts will determine the amount of disposable income.” But it is apparent that debtors' lawyers will have plenty of ground to argue that there is very little “disposable income” in most cases due to the definition un- der the SBRA.

Alternatively, a debtor could distribute some of its property to satisfy the “fair and equitable” test. The debtor would have to prove the property's value is higher than the value of the "disposable income" over three to five years. For example, if a debtor owned personal property that was no longer needed to operate the business, such as excess land, obsolete inventory, or idle machinery, it would be possible to turn that property over to the Subchapter V trustee to distribute to unsecured creditors and meet the "fair and equitable" test—allowing the debtor to retain its equity interest.

As noted at the beginning of this article, SBRA actions allow debtors to save significant expenses compared to other types of bankruptcy. These fees and costs can range into hundreds of thousands, and even millions of dol- lars, depending on the bankruptcy's complexity. Under Chapter 11, creditor committees are often tasked with investigating and litigating potential claims against secured creditors. Since creditor committees do not exist under Subchapter V, debtors will avoid the occasional substantial costs associated with paying professional and legal fees that creditor committees incur. Sut›- chapter V cases are also less expensive for debtors because they do not have to pay the fees of the U.S. Trustee, the independent attorney commonly tasked with protecting the rights of the unsecured class of creditors. (This class usually consists of creditor claims that are too minor to be litigated in bankruptcy court, such as those related to trade payable suppliers or individual employees.)

In addition, unlike with Chapter 11, a debtor does not have to pay all administrative costs when the plan is confirmed under Subchapter V, and a court-approved disclosure statement is not required. Under Chapter 11, disclosure statements are required to provide adequate information about a debtor's financial affairs so a creditor can decide whether to accept or reject the proposed plan. In addition to saving costs, forgoing a disclosure statement requirement allows debtors to confirm plans much more quickly than in Chapter 11 cases, where a statement typically must be approved 28 days before any confirmation hearing. This difference greatly expedites the bankruptcy process, so creditors must act quickly when dealing with Subchapter V filings.

Subchapter V means differences in the trustee's role as well. An SBRA proceeding's standing trustee is appointed to assist all parties, including the debtor, during the bankruptcy.

The standing trustee's duties include:

1. Accounting for all the property received by the company.

2. Examining and rejecting any claims against the company.

3. Conducting a review of the company's financial condition and business operations.

4. Reporting any fraud or misconduct to the bankruptcy court.

5. Appearing at the status conference and materially significant hearings.

6. Producing a final report of the case for the bankruptcy court.

7. Assisting, as necessary, facilitation of a reorganization plan.

8. Distributing certain company property in accordance with the reorganization plan.

9. Confirming the company's adherence to the court-approved reorganization plan during the payment period.

How to Approach a Subchapter V Case

While a general primer on the law, such as this article, should help bankers manage the Subchapter V process, creditors should immediately contact a qualified creditors' rights lawyer to advise from the onset of a case. They should also immediately prepare and file proof of claim.

Lenders and their attorneys should discuss if the borrower qualifies for SBRA and discuss the possibility of moving to have the case dismissed if there is evidence that it does not. The creditor's attorney should swiftly contact the standing trustee to obtain any information that has been received from the borrower. The creditor should immediately review the borrower's loan application and other financials the bank relies on, and identify any basis to except the bank's debt from discharge. The bank should also analyze the borrower's projected cash flow and balance sheet to analyze the potential for discharge of the borrower's unsecured debt. All this should take place relatively quickly so that the creditor's attorney can attempt to negotiate favorable terms prior to the 90-day dead- line to file a plan under Subchapter V.

Creditors should also determine, with legal counsel, whether to make what is known as a ‘1111(b) election” under the bankruptcy code. This tool can protect unsecured and under secured (where the value of the collateral is less than the balance of the loan) creditors in certain situations. While there are many complexities to making this election and attorney involvement is critical in certain situations, we believe 1111(b) elections may become more common in Subchapter V bankruptcies. In making the election, the entire claim becomes a secured claim. Second, the election entitles creditors to retain the liens on their collateral until they are paid in full. Third, it entitles creditors to specific plan treatment: A debtor must include payments to the creditor with a present value equal to the amount of the creditor's secured claim had it not been for the election. Finally, the plan must propose to pay the entire claim in full, overtime. (This article Yxom the Ameri- can Bar Association details the upsides and downsides of a 1111(b) election.)

To manage the likely increase in Subchapter V bankruptcy filings, banks must be diligent. As is normally the case regarding all bankruptcy risk, obtaining and periodically examining collateral is key because of the significant risk of being paid nominally on unsecured debt. Banks should identify any distressed buyer that may qualify as a small business debtor. When negotiating a workout, they should consider utilizing forbearance agreements to incorporate provisions that require debtors to classify expenses in a way that makes advantage of the definition of “disposable income.” Going forward, banks might also consider revising the underwriting standards for loans and loan modifications to incorporate SBRA risk. Proactive steps would include establishing a calculation of “disposable income” in the loan application or during underwriting and disclosing that calculation to the borrower for confirmation during the origination process. Establishing this at origination or during annual reviews would help in the event the borrower files under the SBRA and tries to claim a much lower disposable income figure to achieve a larger discharge of debt by the court. The bank's attorneys would have prior calculations that could force better discovery of the true operating capacity of the debtor at the time of bankruptcy.

Conclusion

It is not our intention to make bankers feel like doomsday is upon us as a result of the SBRA. There are some positive items for banks as well as debtors. The SBRA provides a quicker route to rehabilitation for small businesses burdened by unsecured debt. That allows debtors to emerge from bankruptcy with an increased capacity to pay secured debt. And it reduces legal expenses for the debtor due to the expedited process. The SBRA also provides a mechanism to except certain debt from discharge in cases of corporate debtors that obtained loans using fraudulent application.

However, the pitfalls of Subchapter V do outweigh the benefits for creditors. There is significant risk that they may not have time to properly perfect their claims or object to a plan because of the expedited process. This risk is exacerbated because there is no committee of creditors or requirement for a disclosure statement as in a typical Chapter 11 case. It is also likely that any unsecured deficiency claim will be discharged with no distributions based on ‘disposable income,” leaving many banks facing increased charge-offs and losses. Similarly, individual guarantees that are otherwise unsecured will have remote value since they can be eliminated in an SBRA proceeding, further impairing loans and eliminating other sources of repayment and collection.

Since there is very little SBRA case law to date, it is impossible to predict the law's full effect. However, bankers should be aware of the process and potential implications, and leverage the knowledge and expertise of legal counsel to help navigate this unexplored legal area. They should also review their portfolios and exposure for any concentration of bankruptcy risk, and consider ways to proactively work with customers to mitigate risks inherent in the SBRA process—or even liquidate at-risk portfolios today.

As a side note, banks should always consider loan sales as an efficient resolution mechanism to minimize losses today (your first loss is sometimes your best loss). Portfolios that have SBRA characteristics may be considered for sale today, even if they are still performing. There are buyers that would be interested in buying these portfolios, albeit price adjusted for the higher risk factor. (This RMA Journal article provides some tips.) Finally, banks should consider factoring potential SBRA losses into forecasting and risk rating systems to ensure they are appropriately recognizing the loss given default and have appropriate loan loss reserves established on their balance sheets.

Core Concepts: The Evolution of Private Credit and What It Means for Banks
By JASON ALPERT, CTP, CRC
ProSight Financial Association, November 2025

Historically a niche industry that served distressed borrowers with creative structures, private credit has evolved into a segment that also serves borrowers with products resembling traditional bank loans. This new focus has helped private credit to grow exponentially. The private credit market is widely estimated to have hit the $2 trillion mark in 2025 and is expected to continue its rapid rise. With the Federal Reserve Bank of Boston expecting a $3.5 trillion total by 2028, private credit is often seen as a serious threat to traditional banks that are already facing fierce competition from credit unions and fintechs. Meanwhile, some regulators have expressed concern about the potential systemic risks of such a sizable sector. But the big picture can be nuanced. It’s also the case that private credit firms can act as a safety valve for their bank competitors, purchasing stressed/distressed loans from them and offering capital relief to their borrowers, making at times for something more like a strategic coexistence.

Private Credit vs Private Equity

Many are familiar with private equity, where sophisticated investors pool resources to invest in companies that are not publicly traded. With private credit, investors provide debt financing without staking any ownership claim. While this relationship limits private credit providers from influencing a borrower’s business decisions, it also allows them to avoid lender liability risks. A private credit deal is also less risky to the funding source than private equity. The funding sits higher in the capital stack that determines the order of who gets repaid among a company’s stakeholders, and is often secured by collateral. And the returns for lenders and investors can put private credit in a sweet spot, providing a premium above high-yield bonds and threatening less risk—albeit promising smaller returns as well—than private equity funding. These attractive and fairly reliable yields are part of the reason for the increasing popularity of private credit funds as alternatives to stocks and bonds.

Private credit firms often target so-called “unbankable” companies. Despite the market’s movement into more traditional lending, many private credit deals still go to borrowers deemed too risky for banks due to factors such as high leverage, a limited operating history, regulatory restrictions, and credit policies. It’s not uncommon, for example, for private credit firms to provide bridge financing in the commercial real estate space when banks are not willing to extend a maturing loan on the same property. These deals allow borrowers to find bona fide refinance sources. Once these credits stabilize, borrowers are known to seek funding once again from a traditional lender.

When Private Credit Is a Banker’s Foe

In addition to borrowers who are forced to turn to private credit, some companies choose it over available bank financing because of flexibility in terms, advance rates, loan-to-value limits, and covenants. Private credit deals may also allow for payment-in-kind interest. This creates a difficult choice for banks that want to compete. Banks that consider loosening lending standards could face a reckoning in the form of a higher rate of non-performing loans. Borrowers are also appreciate that private credit suppliers are often “flatter” than banks with rigid hierarchies and bureaucracies. This results in the ability to turn around loan approvals quickly, a critical advantage in today’s fast-paced business environment.

Closing Thoughts

Banks cannot, and should not, mirror private credit’s risk appetite given their deposit-funded model. Nor can they rely on lawmakers to curb competition through regulations. While some banks go head-to-head with private credit, others may choose to coexist, allowing it to take on the risky thickets of the financial forest while banks cultivate stable ground for prime borrowers. In the meantime, strategic partnerships are emerging. Some banks have purchased interests in private credit funds. Others provide financing to them, with the Federal Reserve putting the number at $95 billion in 2024. Regulators have expressed concern about the risks of private credit funds lacking discipline or equity to support their loans in a downturn. The Financial Stability Oversight Council(FSOC), for one, warns that interconnectedness between private credit firms and the banks that fund them via warehouse lines could create a feedback loop—distressed loans cycling back to banks if these funds default, reintroducing toxic assets to bank balance sheets. Sensible policies, such as stress testing banks’ exposure to private credit funds, could mitigate the risks without stifling the benefits of this coexistence.

Case Studies, Cautionary Tales & Relationship-Driven Workouts

Where nuance, diligence, and judgment matter most

Walking The Land Leads To A Spooky Surprise

By JASON ALPERT, CTP, CRC

The RMA Journal, April/May 2023

THE LATE OCTOBER sun was sinking when Roberta Simona pulled up to 1 Industrial Way. Earlier, as she rushed out of her downtown office at Earnings Bank to walk this property, she had thought about going back to her desk for her sneakers. She decided against it.

"Leaving the sneakers behind wasn't very good risk management," she muttered, crunching across muddy gravel. But the reason Roberta was plodding through the mud was absolutely good risk management. She could still hear the words of her former boss, Wilson Charles—"Workout Willy"—ringing in her ears "You've got to walk the land!" Wilson would say to his workout team. "It's not called a property scan. It's called a property inspection." Another of Workout Willy's practices? Reading appraisal reports. "Every. Single. Page."

Pulling her sweater around her, Roberta comforted herself with the thought that the deal she had worked with former auto dealership owner "Honest" Bob Locke was a pretty good one for Earnings Bank. As workout deals go, this one could have gone much worse. For one thing, the bank should have acted earlier in escalating the loan to workout. A few years back, the Hyundais weren't exactly zooming out the door and Bob's revenue fell by over 50%. at triggered a debt service coverage default. With payments continuing to arrive on time, the first line hadn't taken any action.

The $8 million loan did not go to workout until the bank learned—not from Honest Bob—that Bob had sold his Hyundai franchise rights. at triggered a change-in-business default. Bob might be honest, but he was not always forthcoming.

But here was Roberta, about to make Earnings Bank whole. She hoped. If that line she noticed in the appraisal—the one that prompted her to rush over to the property with the wrong footwear—turned out to be a false alarm.

In exchange for the bank wiping out his debt, Bob had agreed to simply turn over the property. Which, it turned out, appraised at $8.8 million—more than the amount of the original loan. e bank could sell the property, and there would be no need to spend money and time on legal proceedings against Bob. Done and done.

Word was that Bob had done quite well with the sale of the franchise, which the new owner put in a different location across town. Perhaps to the tune of around $2 million. That would explain why Bob was ne with walking away from his equity in the now vacant property. Roberta was curious to know if that figure was true. But the important part, she reminded herself as she stepped onto a path leading from the dealership's service building to an impressive wall of foliage, was that the bank could cut its losses to zero. It might even make a little on the deal!

But Roberta couldn't shake her worry over that odd line in the appraisal. It said $150,000 in value had been subtracted due to something labeled "PETCEM" on an attached lot. She and her colleagues had puzzled a bit over that one back at the office. Was it … petroleum and cement? Was the property sitting on a Superfund site? She hoped it was just a mistake.

As Roberta peeked around the wall of foliage, her heart sank. is didn't look like any industrial-park green space she'd ever seen. The meaning of "PETCEM" was coming into focus.

She spotted a gate wedged into the tight wall of evergreen, and stepped into a picturesque ruin: overgrown grass, gnarled ornamental plants, and weathered marble everywhere. e last beams of light from the setting sun played across worn headstones: Champ. Heidi. Max. "Charlie, 1932 1941. Faithful Companion." All single names. All cute. And all the lives seemed heartbreakingly short.

Roberta was standing in a pet cemetery.

"Uh oh," Roberta thought. Time to call Earnings Bank's counsel, Sam Mendoza.

"Sam," she said. "I never thought I would ask this question, but what kind of issues are we up against if we end up with a property that includes a pet cemetery?"

"Why do you ask?" Sam said.

"Because I'm standing in one right now," Roberta said. "It's attached to a parcel we have a deal to take back from the borrower. A really good deal, too."

"OK, well, if you start to hear sounds from under the ground? Like a pet has been reanimated? And is now evil, and is trying to scratch its way to the surface? Well, as the rm's legal counsel I strongly advise you to get out of there."

"What the heck are you talking about, Sam? Just tell me what kind of situation Earnings Bank would be in if we got stuck with this land." (Roberta was not a fan of the horror genre.)

"Well, legally I don't think it would be a problem," Sam said. "The bank would be able to clear the pet remains and sell it to a new owner. There is no legal risk."

"No legal risk. Yeah, I think I see where you are going," Roberta said, walking toward a weathered gazebo that had just caught her eye. "But it sounds like we would be opening ourselves up to a heap of reputation risk. From the headstones here, it looks like the animals all died decades ago. But I have no idea if people still visit here and if they would be upset if something happened to this place." She had a vision of the WKRT news truck pulling up next to the cemetery as workmen hauled off the remains of once beloved pets, picketers in the background.

Shaking the vision off, Roberta noticed a bronze plaque affixed to the railing of the gazebo, which, it turned out, was a memorial. "Here lies Fred Blurt, Friend to All Animals: 1870-1943."

"Uh, Sam? What would happen if a ... a ... person were buried in this pet cemetery?"

Back at the office the next day, Roberta dropped into a chair in Sam's office with a sigh.

"So, you survived the pet cemetery, I see," Sam said.

"No thanks to you! OK—tell it to me straight. What are we looking at?" "I hate to say it, but this situation is a real problem for Earnings Bank," Sam said. "It would not look great if we dug up those pet remains and moved them somewhere else so the bank could sell the property more easily. But the dead guy … what's his name again?"

"Fred Blurt," Roberta said.

"What is he doing in a pet cemetery?"

"That whole industrial park used to be the grounds of the Blurt estate. Fred was an animal lover. Seems he wanted to create a space where people could remember their pets. He loved it so much that he decided he wanted to be buried there himself."

"That probably explains why that green space still exists," Sam said. "Dead Fred really complicates things. To move remains to another burial site, you need approvals, you need to notify next of kin, you need a coroner. As long as Fred is there, the owner of that land has to maintain the property, ensure that next of kin has access to it—there are a ton of requirements. How did a car dealership end up with a pet cemetery on its property, anyway?"

"The appraisals don't say much, but apparently it had something to do with them expanding years back. To build, they needed more drainage, and the only way they could get it was to buy this adjacent grassy area. Which I guess just happened to include this pet cemetery. Well, pet and human cemetery, actually. Now I have to figure out a way I can preserve this deal," she said, before heading back to her desk to think.

Was it possible, she wondered, that a buyer would want the property along busy Route 11 so badly that they wouldn't worry about taking ownership of the pet (and human) cemetery? Maybe it's as simple as that, she thought. But the market was pretty soft—companies were in a position to pick and choose. And why would a buyer willingly take on the same risks the bank was trying to avoid?

Then again, if she couldn't strike a deal with Honest Bob, and the bank ended up with the property after a lengthy foreclosure battle, it would be out the money the deal was going to save on legal work. And the bank would end up owning the cemetery anyway.

Maybe Earnings Bank could simply leave the pet cemetery out of the deal. Take the usable land from Bob and say, "You know what? You keep the cemetery parcel. Good luck with it!" But then she remembered the drainage requirement.

And then it hit her.

"Hmm," she thought. "Yes, that might work. Bob might not go for it. But suppose he does?"

…

The next day, Roberta arranged to meet Bob and his attorney at the former car dealership site for a final negotiation. She had given a lot of thought to the location. Walking through the cemetery would allow her to illustrate the bank's plan. At the same time, the hulking empty buildings and vast empty parking lots of the dealership would remind Bob of how badly he wanted to finally be free of his loan—a point he had made several times to Roberta. She could tell he was being honest about that.

It was a glorious fall day. Bright sunlight, not a cloud in the sky. Roberta had a good feeling as she set out the conditions and reasons for the deal.

"Bob, I know you want to settle this as much as Earnings Bank."

"I do," Bob admitted. "And it sounded like we were getting very close to a deal. So, what's the problem?"

"You're standing in it, Bob," Roberta said.

"Oh." Bob's gaze flicked among the headstones. "The pet cemetery. I almost forgot it was here. So, what can I do?"

"Earnings Bank wants you to keep ownership of it," Roberta said, "and we'd like you to grant an easement that will allow us and the eventual new owner of the property to use the land to meet the county's drainage requirement."

"I don't know about this."

Just then, Bob's attorney chimed in.

"Can you please give us a moment?" he said.

"I'll leave you guys to it," Roberta said. "Enjoy the beautiful day!"

…

Roberta didn't know what Bob's attorney discussed with him as they sat on a marble bench amid the graves. On a crisp fall day, it was a rather lovely space. Maybe Bob shared her soft spot for animal companions. And maybe he was eager to reach a deal. In any case, Bob called later that day and agreed to the bank's terms. Six months later, Earnings Bank sold the land for the ap praised $8 million to a Ford dealer that was looking to move from a smaller site.

Roberta received high praise from her Earnings Bank colleagues and boss es, who lauded her workout acumen. It felt great. But so did the realization that she had done a thorough job. She had read and understood the details of the appraisal, and, in a move that would have delighted old Workout Willy, wasted no time in walking the grounds when she suspected a problem.

Not long after the sale closed, Roberta dropped by the cemetery again with Larry, her beloved golden retriever. She was a little surprised, and also pleased, to see that the property wasn't just groomed—it had been manicured. Maybe Bob had recognized the charms of the place. She and Larry sat together for a few minutes in Fred Blurt's gazebo, among the spring blossoms, remembering all those resting there—the pets, and the man who loved them—before moving on.

The Workout Window: Razing Some Red Flags
By JASON ALPERT, CTP, CRC
The RMA Journal, April/May 2024

QUESTION: On a recent outing to inspect a small office building, I discovered that the building was gone. My customer had razed it. All that was left was a vacant dirt lot with a sign declaring that a new car wash was coming soon. We reached out to the customer immediately and, after several attempts to connect, they finally responded, saying that they had lost all their tenants and that the new "highest and best use" for the land was to put in the car wash. The loan was still paying out as agreed, but now the customer wanted an interest-only construction loan. What should we do?

JASON: Immediately transfer the loan to your workout group and engage outside counsel. The lack of communication from the customer is unacceptable. They have already de faulted on several major conditions of the mortgage, and you now are under-secured given that there is no longer a building on the site. You need to default this loan now and this untrustworthy customer needs to find a new lender ASAP.

Faulty Electronics

QUESTION: I have a $1.1 million line of credit to an electronics distributor that has about $950K outstanding, secured by accounts receivable and inventory. A/R turns increased to 65 days (up from 20) and days on-hand inventory tripled to 180 days. The customer also reported losses last year and doesn't believe there will be improvement over the next year from a cash flow perspective. How should we treat this upcoming renewal?

JASON: Since you didn't mention a real estate loan as part of this relationship, I assume they do not own the space they are using to operate and store the inventory. At renewal/ modification, then, you should obtain a landlord waiver (if you don't already have one) so you have access to the inventory that secures your loan should your customer stop paying their lease or file bankruptcy. The DOH tripling is a major red f lag. Given the industry, you need to ask why they aren't moving inventory and whether the inventory itself is at risk of obsolescence. This deal demonstrates distress and should be sent to your workout group. The resolution should focus on shoring up documents and terming out the portion of the debt that is not revolving. If there is any hard collateral (equipment or any related real estate) you should seek to secure the line ASAP. Good luck!

Losing Faith in a Church Loan

QUESTION: My portfolio has a $700K church loan that is well secured at a 55% LTV. We are in a small community and the pastor of the church died two years ago, resulting in a 60% decrease in giving units. The church can no longer afford the loan payments. How do we resolve this situation without harming our ability to do business in this community?

JASON: Lending to churches or nonprofits is always rife with risk, especially from a reputational standpoint. These loans are often non-re course and foreclosing a church (in the absence of outright fraud) can be detrimental to the long-term ability of the bank to do business in the community (even if the church is not well attended). In restructuring a church loan, you'll need to get church leadership to recognize the problem and to accept professional financial assistance, even if it means increasing the scope of work their CPA typically provides. Addition ally, the church should establish a finance committee to provide budgets and periodic statements that the bank will require in any restructuring agreement. I would also consider right-sizing payments to what they can afford short-term and bringing in the maturity or having an expiration period when loan payments go back to normal and support the full debt. Hard discussions might need to take place regarding selling non-critical assets (excess land/vehicles) and cutting services, missions, or even pastor/ staff salaries. The church might also want to consider leasing out space to groups and organizations to generate cash flow, or even spinning off services such as day care or schooling. God willing, you can find a win-win solution for the church!

The Workout Window: The Microbrewery Glut 'Ales' a Lender
By JASON ALPERT, CRC
The RMA Journal, February/March 2025

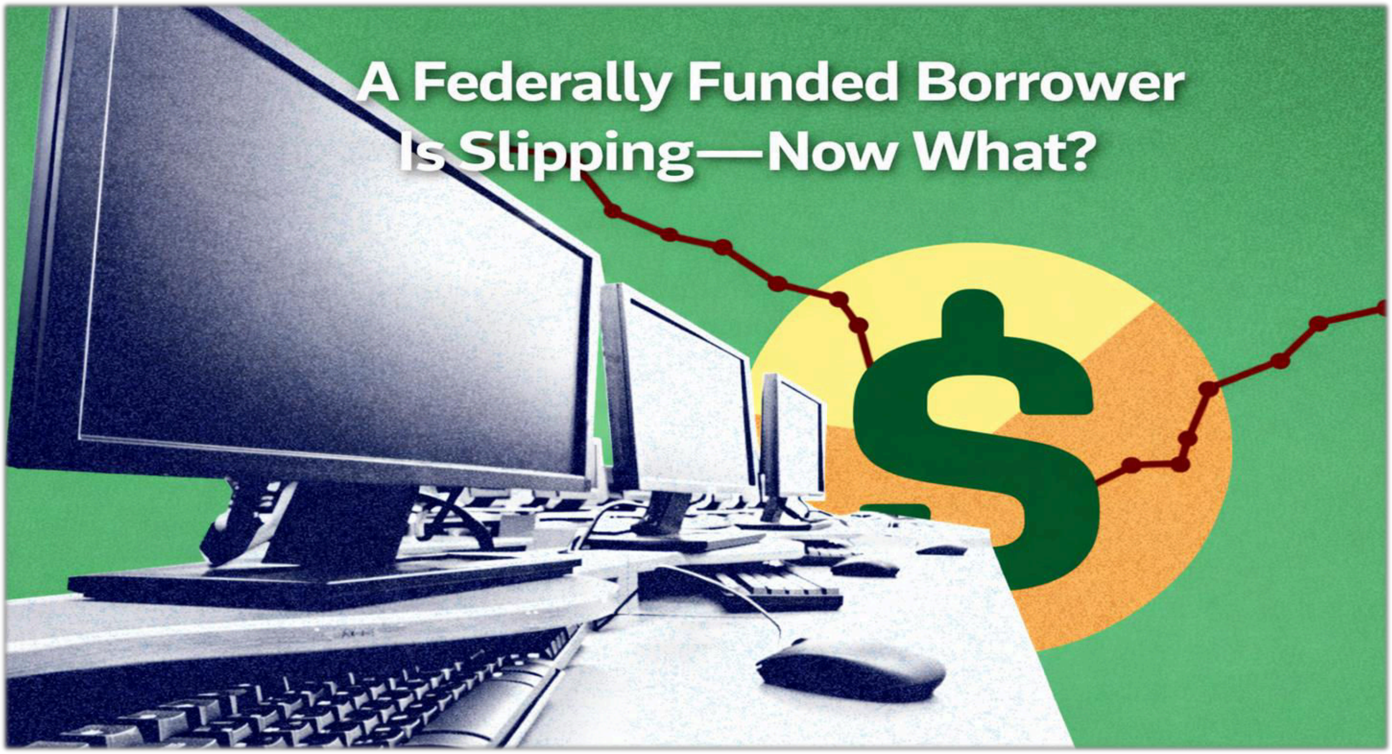
QUESTION: One of our borrowers, a microbrewery, has suddenly gone from rousing success to habitually late on payments—and missing on covenants related to outside borrowing and operating performance. Our relationship includes a $250,000 unmonitored line of credit, a $250,000 permanent working capital loan (this was to help with an expansion-to-distribution strategy), and a $600,000 term loan secured by the brewery's equipment, which was appraised at $1 million on a "net orderly liquidation value" at origination three years ago. The business is losing large parts of its clientele to a microbrewery that opened nearby with a full kitchen (our borrower relies on food trucks in the parking lot) and beer that is rated higher on the Untappd app. Our borrower wants very much to turn things around and continue paying on its loan. And we would like that as well, of course. Even more so than with other borrowers, we're worried that, in a liquidation, the amount we would recover would be meagre because so many breweries have been failing, and there is a glut of related equipment available for sale. Can you provide some clarity on the pluses and minuses of working with this particular borrower vs. foreclosing? I have to admit that from my vantage point, things are looking pretty, well, hazy.

JASON: What you described is typical of a very competitive industry with limited barriers to entry. The microbrewery industry is no different. As you identified, the microbrewing market is oversaturated. Meanwhile, consumer appetites are changing, with more people substituting other alcoholic drinks like hard seltzer for beer. This will be a factor in the path you choose. To get a better sense of the challenge, I reached out to Chris Burton of Chicago-based Loeb Equipment, which sells, appraises, and auctions off all kinds of equipment. Burton, an appraiser, told me: "Five years ago brewery equipment would retain most of its original appraised value, sometimes trading as high as 80- 90%; today the market is only bringing a fraction of that value at auction, many items bringing less than 20% of their original value." In other words, in a foreclosure/replevin scenario, the bank can reasonably expect to recover only a fraction of the value of its collateral in cash. As you can imagine, such a big loss can make even the most "heady" banker sober up, and fast!

Your bank would probably be best served by working with this borrower, assuming that they are transparent, and willing and able to do so. The bank will need to feel confident that the management/ownership team can make the right strategic decisions to work through their challenges and right-size the business. To start, your bank should formally default the loan(s), downgrade the credit, and transfer it to workout. From there, the bank should require updated financial information and obtain a new appraisal of the collateral (on a "net orderly liquidation value") and the borrower's strategic plan and projections to turn the business around in the face of this new competition.

Assuming the going-forward plan is feasible and—most critically—you believe management can execute, restructuring the deal is probably the best option. Be sure to stress test the pro forma cash flow projections and have the customer walk through various revenue/cash flow generating activities. Some, such as opening its own kitchen or developing new products or distribution models, may require more capital. (It should be stressed that any capital for expansion or strategic change come from equity or outside the bank.) Investment might warrant payment relief on the debt, hopefully in exchange for additional guarantees and/or collateral. If the borrower has no resources to exchange, then a short-term loan modification (12 months or less) may still be warranted. But be sure to tighten up documentation, reporting, and covenants to closely monitor the loan. In addition, make sure to cross-collateralize/cross-default all loans and obtain a landlord lien waiver, as it seems that the borrower doesn't own the real estate the business uses, and you will need access to the equipment in the event of future defaults or litigation. The last thing you want in a litigation scenario is to lack access to your collateral because the landlord has control of the property due to a default under the borrower's lease obligation.

If the customer doesn't have the ability to turn the business around, or if the bank seeks to exit the deal, there are other options that may not require litigation, such as offering the customer a discounted payoff to refinance or sell the business (perhaps to the new competitor). Cheers.



The Workout Window: A Federally Funded Borrower Is Slipping—Now What?
By JASON ALPERT, CTP, CRC
The RMA Journal, April/May 2025

QUESTION: I'm a relationship manager at a regional bank, and I'm seeking your expertise regarding a middle-market non-profit borrower in our portfolio, Community Impact Services (CIS). CIS is a 501(c)(3) based in the Midwest, delivering workforce development and job training programs for low-income communities. The organization generates $12 million in annual revenue, with 75% from federal grants and contracts tied to employment initiatives, 15% from state grants, and 10% from private donations. In its regional workforce development market, CIS maintains an 8% share, competing with larger national non-profits and for-profit providers.

Two years ago, we extended a $3.36 million real estate loan to CIS to fund the expansion of its headquarters, which is now valued at $4.2 million. The loan represents an 80% loan-to-value ratio, fully amortizing over 15 years with a fixed interest rate of 6.5%—aligned with market rates at the time—and monthly principal and interest payments of approximately $29,500. The loan is secured by a first lien on the headquarters property, with no additional collateral pledged. The current outstanding balance is $3.1 million. Recently, federal budget uncertainties and delays in grant disbursements have strained CIS's cash flow, pushing its debt service coverage ratio below 1.0x for the past two quarters. They've requested covenant relief and may need a broader workout plan to stay afloat.

What workout strategies could we employ to help stabilize their finances while safeguarding the bank's interests? I'd greatly appreciate your guidance on this complex case.

JASON: It's clear that CIS plays a vital role in its community and is a valued client of your bank. Restructuring a loan for a non-profit like CIS poses unique challenges: as a 501(c)(3), its loan is inherently non-recourse with no equity ownership to tap—and banks typically hesitate to foreclose due to the risk of damaging their reputation in the community.

In today's volatile economic and fiscal environment, CIS's heavy reliance on federal revenue—75% of its $12 million annual income—heightens its vulnerability. Budget uncertainties and potential contract cancellations could push this borrower toward further defaults or even non-payment. Given this risk profile, I recommend three immediate steps: add the loan to your watch list, issue a covenant default and reservation-of-rights letter addressing the recent breach, and transfer the relationship to your workout team. These actions will allow the bank to monitor the situation closely and respond quickly if CIS's financial condition worsens.

If CIS begins missing payments—whether on debt, payroll, or taxes—or faces overdrafts, consider downgrading the loan further or moving it to nonaccrual status.

Your workout team should engage CIS's management and board in a deep dive that assesses future risks. If government funding is shrinking, how will CIS replace that income? Some nonprofit providers are, by the nature of their business model, dependent on federal contracts. While a few states, local governments, and foundations are stepping in to offer short-term relief, it's unlikely that support will fully replace federal funds.

On the expense side, all options must be explored. With an apparent EBITDA margin of just 3% (about $360,000 on $12 million revenue), CIS operates on a razor-thin buffer. Efficiency gains are likely needed to align expenses with projected revenue. To avoid lender liability, don't prescribe specific cuts, but suggest they evaluate expenses like staffing, overhead, or marketing. (I note your point about workforce development making staff reductions sensitive; perhaps technology or outsourcing could trim costs instead.)

As for the default itself, tailor the approach to CIS's balance sheet. If liquidity is strong (for example, 12 months of operating and debt service coverage) and CIS presents a credible budget showing near-term compliance, consider a forbearance agreement. Pair this with more frequent financial reporting to justify an upgrade once performance stabilizes. If liquidity is weak, leverage the default to negotiate a restructure. Given the revenue uncertainty and tight cash flow, recast the $3.1 million loan from its current 15-year amortization to a 25-year schedule, and shorten the maturity to two to three years from now. At 6.5% interest, this drops monthly payments from about $29,500 to about $20,500, freeing up about $108,000 annually. Direct most of this relief—say, $80,000—into a pledged savings account tied to a new liquidity covenant targeting a one-year debt service reserve over time. Secure additional collateral, such as a UCC lien on all business assets if available, and mandate monthly reporting and forecasts during the workout.

If CIS's condition worsens or management lacks the capacity for a turnaround, it may be time to pivot to an exit. With around $1 million in equity in its $4.2 million property, a sale or sale-leaseback could unlock liquidity while preserving operations. In that case, use the default to accelerate the loan's maturity to one year from today, offering payment relief if needed, with excess cash pledged until payoff. Set clear benchmarks: broker engaged within 90 days, marketing updates or offers by 180 days, and a signed contract in hand at least 90 days before maturity.

This approach balances CIS's mission with the bank's risk, offering flexibility while protecting the bank's position. Best of luck!

Section III: Castlebar Holdings

About The Author

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Jason Alpert is the Founder and Managing Partner of Castlebar Holdings, a distressed investor that provides private debt and equity solutions to troubled middle-market C&I, ABL, and CRE loans. Jason is also an advisor / consultant for banks and credit unions in resolving and mitigating risk within their problem loan portfolios.

Jason created and led the distressed portfolio sale team for Wells Fargo, pooling and selling criticized and classified commercial loans in the secondary market. In just under five years, Jason's team was able to sell over $1 billion in assets in 38 States achieving above market results and large recoveries for the bank.
Jason also led a workout team of commercial bankers, dispersed across the eastern United States. Jason's team was able to restructure and resolve distressed loans to a wide variety of middle-market commercial borrowers ranging from a variety of asset types and industries.

Jason was a highly decorated Banker at Wells Fargo, having been awarded the Bank's Golden Spoke Award (top 1% performer), Pinnacle Award, and Corporate Innovation Competition winner. He was also recognized as a "40 under 40" in the Tampa Bay Business Journal in 2021.

Jason is also an Adjunct Professor at the University of Tampa teaching "Introduction to Global Business" and was named Most Outstanding Part-Time Faculty for the College of Business in 2022. The required course covered a wide range of business disciplines and a variety of business cases and simulations.

Jason is on the Editorial Advisory Board of the Risk Management Association Journal as well as the Florida Chapter of the RMA and Turnaround Management Association. Jason has been published many times in the RMA Journal and writes the "Workout Window" column for the Journal. He is also a Judge in the University of Florida's annual Next Big Idea Business Case Competition. He is a highly sought-out speaker presenting at various professional conferences. Jason has MBA and a bachelor's degree in Finance from the University of Florida.

What We Offer

Castlebar Holdings

Providing Asset Resolution Solutions to Financial Institutions

Fast, discreet, and bank-aligned resolution strategies backed by decades of experience in banking and private investment.

PE Investments - Loan Acquisition – Strategic Advisement - Refinance

Castlebar Holdings is a specialized investor and strategic advisor dedicated to helping banks with distressed commercial loans and complex credit situations. Our mission is to partner with special assets groups, credit officers, portfolio managers, and executive leadership to deliver solutions to preserve value, mitigate losses, and reduce portfolio risk. We offer unique solutions, including private equity investments in distressed borrowers, to help bank resolve their most challenging credits.

Private Equity Solutions for Challenged Companies

We can provide long-term operational and equity support to companies in transition or distress. We focus on small to middle market companies with targeted investments of between $5-40MM across a wide range of industries in both the US and Canada. When refinancing with another lender is not an option, private equity investment may be the perfect solution for all involved

Private Credit and Loan Acquisitions

Private Credit (C&I / ABL)

We support private credit transactions for middle-market C&I and ABL financings, working as an integrated member of the deal team. We contribute to transaction evaluation, structuring discussions, and ongoing coordination to ensure alignment with defined credit objectives and risk profiles.

Real Estate–Secured Loans & Notes

Separately, we partner directly with investors acquiring real estate–secured notes, with mandates defined by specific property types and geographies..

Strategic Advisement & Training

We support banks with strategic guidance on problem loan resolution, policy development, and regulator-facing reviews. We also provide hands-on training through our *Workout Playbook* and seminars such as Workout 101, Workout 201, and our new Workout 301. We also assist with exit strategy and loan sale execution for institutions looking to sell portfolios or even individual loans.

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