

THOUGHTS ON THE PSYCHOLOGY OF A WORKOUT

by Barry Freeman, 06/08/10

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The psychological interplay between debtor and creditor in a workout of a classified or defaulting loan frequently involves many issues that go beyond the "law" and the language of loan documents. There may well be significantly conflicting emotional pressures inherent in this situation, which needs to be recognized, understood and dealt with.

The bank generally will have well-documented loan agreements that provide for a myriad of remedies, some draconian and requiring considerable thought before threatened or exercised. However, in the "chess game" of the workout, psychological issues may strongly influence the action and rational thought must govern the action of the parties.

Each loan is sui generis. The leverage and perspective each party brings to the table varies, and actions of the lenders must be tailored to the particular credit, personality and background of the borrower. From the borrower's perspective, the situation may threaten its economic survival and like any other cornered animal it may do things to survive, which the lender may view as questionable. Couple this with the anxiety of "losing it all" and one may understand the psyche of the borrower approaching the workout process. Acknowledging this mindset and emotional state may assist the lender in its negotiations.

How the loan adjustment department (LAD) is viewed within the institution, is a critical factor in the success of the workout. If LAD officers ostracize and engage in recriminations of the line officers it

will have an adverse impact on LAD's success. The line officer must feel supported and not a "sacrificial lamb." Senior management must support and recognize the "pressure cooker" atmosphere LAD operates within. The current economic pressures and requirements of regulatory agencies add significant pressure to LAD, which pressures need to be dealt with, but not projected and placed upon the borrower. The workout is a team effort for the lender.

Making immediate demands for possession and full payment at the outset may be precipitous and one must be "careful for what you wish for." Issues of lender liability and remedies are not dealt with here, although such concerns are of extreme importance and must be considered in any workout. However notwithstanding these issues, careful analysis, evaluation of the credit and a plan to exit must be accomplished at the outset by the lender since "the first loss may be the cheapest" and pursuing restructure may not make economic sense.

From the borrower's perspective, economic survival, egos, and success of past generations cloud objective evaluations. The reflection the borrower sees in the mirror may not be accurate. How and who conveys this misconception is convincingly conveyed to management is a critical step in the workout process.

Lenders differ on who is or should be responsible for the workout function, and whether and at what point internal responsibility for a credit should be assigned to LAD. Some lenders follow the policy of

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retaining the lending officer "womb to the tomb." Smaller banks may not have the luxury or ability to afford separate LAD departments and have no choice but to leave the credit with the originating officer. Other lenders follow a policy requiring automatic transfer to LAD once the credit has been classified or meets other criteria. Some institutions will immediately place such credit outside with lawyers or consultants to handle.

Some of the pros and cons regarding assignment of the credit to LAD are: LAD is not "tied" into personal relationships with the borrower which has existed for extended periods. LAD may be more objective and existing "personal relationships" can be avoided and neutralized. LAD may avoid the embarrassment and the difficulty involved when a loan officer who has dealt with the borrower in a "friendly" posture over several years becomes more adversarial. LAD may be more willing to acknowledge the truth of and act on the fact that a loss is to be incurred and "bite the bullet." Transfer to the LAD and the elimination of the line officer from the credit may polarize the parties, eliminate cooperation, and invite litigation and hard lines being taken by both sides. LAD's personnel may lack knowledge of the borrower, its psychology, background history, type of business, and the unique nature of the particular credit and the need to have a working relationship with the borrower. Thus, utilization of both LAD and line officers in a transactional period may be a successful compromise approach, however if there is a LAD department, the current thinking is that that department is responsible for the credit and will make all command decisions.

The borrower frequently will not or cannot accept its failure. Frequently, this inability translates to an individual with a strong ego and reluctance to make changes. Lender's "request" to insert consultants who will have operating authority further compounds the mistrust and friction that may exist. The borrower may well be embarrassed and its "loss of face" may be a significant issue to deal with and understand. Many middle-market companies are and have been managed by a family member who is accustomed to making all management decisions and not being challenged, will resist criticism and suggestions that he or she step down. Thus, the initial meeting with the bank, if not properly orchestrated, oftentimes is not only non-productive but destructive. Generally speaking, the more sophisticated the counsel and consultant on both sides of the table the more efficient, cost effective and successful the workout possibilities are. Permitting the borrower to vent at the first meeting and being attentive and concerned with the presentation, even if totally unacceptable, will help to set the tone of a cooperative effort.

If there is actual fraud involved, there is nothing to "work out" and the lender will likely aggressively pursue enforcement and remedies. However, "borrower fraud" is usually not the case. As noted above, economic survival and the threat of loss and income sources to support employees, family, etc. often cause a breach of loan covenants. These breaches are certainly offensive, not to be sanctioned, but if viewed from the borrower's perspective may be more understandable and not constitute actual fraud. If a payroll was due and account receivable proceeds were diverted for that purpose, it will be not received well, but perhaps the motivation for same understood and corrective

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measures (lockbox) taken to prevent a reoccurrence.

Inserting a chief restructuring officer (CRO) or other consultant is often critical. Working through competent borrower's counsel to have that individual address the issue with the patriarch/matriarch may be more palatable and successful. The choice of the CRO, if done by the bank, may be resented and also present other issues that may have to be dealt with if the workout is unsuccessful in the future (i.e., lender liability claims). Obviously, if the bank is requested to make a recommendation, it will do so and usually three recommendations are provided. However, the lender liability issue should be considered and the choice of the CRO accomplished through recommendations of the borrower's counsel. Generally, the CRO will be well-known to both parties and the CRO can be suggested by the borrower and if that individual is satisfactory to the lender, it may be a more palatable choice. No matter the method or who is chosen, the engagement and the entire workout is dependent upon credibility and transparency. If either of these critical factors does not exist and a free flow of information is not obtained, the workout may be doomed from the outset.

The foregoing brief discussion does not address the workout plan or structure. Having at least a preliminary plan prior to meeting with the borrower is extremely important. The purpose of this article is to suggest that the parties and their professionals take a step back and try to understand the other's perspective and stresses. Nothing in this article suggests that the lender sacrifice any right or forego any remedy in its negotiations with a borrower. Sometimes a dose of reality is a must, but the approach, delivery of the message and its timing is worth some thought.

A workout is analogous to a chess game. All may not be equal, but each can make moves and counter-moves. Gauging the leverage and motivating factor for each is important. A productive approach is for the lender to try and work within the proposals presented by the borrower. Borrowers are generally optimistic and will overstate their position and their ability to perform. When they default, it was their plan, not something forced upon them by the lender. Thus, the acceptance of the failure and willingness to be more flexible may be easier to obtain.

The workout is a "fifteen rounder" and "win some-lose some." Comprehending and working with the non-legal issues play an important role in both parties' approach and success.



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