



LOAN MODIFICATIONS FOR CALIFORNIA NONPROFITS AFFECTED BY THE ECONOMIC DOWNTURN

Publication Date: August 2009

This information sheet is published as part of Public Counsel’s “Turning the Tide” program, a new initiative designed to meet the changing legal needs of our community in light of the economic downturn. You can access answers to other frequently asked questions (“FAQ”) and updated resources for nonprofits & small businesses at www.publiccounsel.org/practice_areas/community_development.

This information sheet provides an overview of some of the options available to nonprofit organizations that are struggling to meet their mortgage and other loan payments. The specifics regarding these options and how a borrower can go about taking advantage of them will vary from one borrower to the next and from one lender to another. Regardless of your organization’s situation, however, this process can seem complex and daunting.

In this information sheet, one of these options, loan modification, is explored through a series of questions addressing many common concerns of nonprofit organizations that are struggling to manage outstanding debt. The answers offer a starting point for a nonprofit to evaluate when it may be appropriate to modify a loan, what some other alternatives may be, and how a loan modification might help the nonprofit organization to keep its doors open during this economic crisis.

This information sheet is provided for informational purposes only and does not constitute legal advice. While this information can help you understand the options available during a period of financial distress, it is very important that you obtain the advice of a qualified attorney. Qualifying nonprofits may be eligible for free legal consultation or representation to assist with these matters. For an application for legal assistance for existing nonprofits, go to <http://www.publiccounsel.org/tools/assets/files/Application-for-Existing-Nonprofits-2010.doc> or call Public Counsel at (213) 385-2977 ext 200.

OVERVIEW OF LOAN MODIFICATIONS AND OTHER ALTERNATIVES

Our nonprofit organization is struggling to make its loan payments. What are our options?

In some cases, the monthly payment that a borrower is required to make on a loan may exceed what it can afford. This puts the borrower at risk of delinquency and, eventually, of defaulting on that debt. *If a borrower ceases to make required payments, the lender will be able to foreclose on any property that serves as collateral for the loan and/or sue for the deficiency, resulting in a ruined credit rating.* In order to continue receiving payments and, thus, avoid classifying the loan as bad debt, or to avoid the costs of foreclosure or a lawsuit, the lender may agree to change the terms of the loan to make the payments more affordable.

Loan modification is the process by which the terms of a loan are changed to terms other than those originally agreed upon by the borrower and the lender. A lender may agree to modify a loan prior to a late payment or actual default (failure to make required payments) but modifications are more commonly agreed to after a borrower has fallen behind on making payments. It may also be an option during default, foreclosure or bankruptcy.

Example: Foreclosure of real estate starts with various demand letters, continues through discussions and negotiations and may eventually lead to a Notice of Default (with rights to cure for 90 days) and a Sale Notice, which provides at least 20 days notice. Generally, lenders are more willing to make concessions further along in the process, especially when the lender will soon be required to reclassify the loan as non-performing or bad debt. This is because, in each case of reclassification, the bank would be required by federal regulations to set aside (or obtain) additional capital in its loss reserve, which banks may wish to avoid. Also, the "work out" departments of banks – who get the loans after the regular loan officer believes he/she cannot obtain performance by the borrower – often have greater latitude in modifying the terms of a loan.

Prior to pursuing a loan modification, however, a borrower must first carefully examine other potentially prudent alternatives. Three such alternatives described here are forbearance, refinancing and bankruptcy. The borrower's problems making payments may be short-term. In the event that the borrower is struggling to make payments now but is able to demonstrate to the lender that its financial condition will soon improve, the borrower should approach the lender with this information. If the lender is satisfied that the borrower will be able to continue the current payment schedule in a few months, the lender may agree to forbearance or postponement of payments, sometimes without penalty. It is important for the borrower to keep in mind, however, that meticulous documentation that

demonstrates that the borrower is engaged in prudent fiscal measures and conservative spending such that the borrower's financial condition is likely to permit payments at a later date, is essential and will give borrowers the most leverage here and in any negotiation.

Refinancing is a process by which the borrower obtains a new loan to pay off the existing loan. Refinancing may be more attractive to borrowers who are current on their payments but afraid that the payments may become unaffordable in the future. Unlike a loan modification, which may only be available to a delinquent borrower, the best candidates for refinancing have solid payment histories and good credit scores. Refinancing can allow a borrower to obtain a lower fixed rate, switch from an adjustable to a fixed rate, change the term of the loan and/or increase the principal balance. A borrower should, however, keep in mind the potential costs of refinancing – closing costs and other fees on the new loan, prepayment penalties on the old loan, the cost of title searches, insurance and escrow and legal fees. Refinancing will only benefit a borrower if these costs are offset by the savings obtained by refinancing and if the borrower can afford all of the up-front fees in exchange for the long-term savings.

Another alternative, though drastic, is **bankruptcy**. A Chapter 11 bankruptcy filing immediately halts (or "stays") most collection proceedings, regardless of what stage they are at, for a period of time. This is designed to provide the borrower a relief period during which its debts can be renegotiated. A lender can move for "relief from the automatic stay," but, if the borrower can show that there is equity in the property (fair market value exceeds the amount owed) or that it is necessary for an effective reorganization, a court may be reluctant to grant such relief. Lenders whose claims are impaired by a proposed reorganization plan are permitted to vote on it. Such plans may include loan modifications, which, in some cases, can be instituted even over the objection of a particular lender. For more information on bankruptcy issues, please refer to Public Counsel's informational sheet entitled "Bankruptcy Issues Concerning California Nonprofits Affected by the Economic Downturn" at <http://www.publiccounsel.org/tools/publications/files/bankruptcyNP.pdf>.

What should we consider if the organization has several loans in repayment?

If the borrower has more than one loan, there are additional issues that must be considered. If the loans are all with the same lender, a borrower may wish to approach the lender about consolidation. If different lenders are involved, it is likely that each will have to be approached separately but is likely to require documentation of how the borrower expects to service all of its loans after any potential modification. A lender will not want to modify a loan if a borrower's other debt will cause the borrower to make late payments or default in the future. Modification is meant to be a solution to the problem, rather than a way to delay the inevitable. Again, the more documentation a borrower can produce regarding financial condition and future performance, the more open to discussions a lender may be.

WHAT TO DO BEFORE COMMENCING NEGOTIATIONS

We are beginning to have cash flow problems and might not be able to continue making loan payments on time. At what point should we approach our lender to discuss a possible re-negotiation of the loan?

The first thing a borrower needs to do is to contact the lender. A borrower can contact the lender even prior to becoming delinquent on payments or defaulting – in fact, it is better for both parties if the contact is initiated as soon as the borrower realizes that it will be difficult to continue making the required monthly payments under the current loan. A borrower should keep in mind that notifying the lender of the borrower's inability to pay will not necessarily generate a response or action by the lender. As the number of defaults and foreclosures rise, lenders are dealing with increasing volumes of such requests and, thus, sometimes refuse to discuss modification or other options if the loan is less than a set number of days past due.

Prior to the loan-renegotiation, what are some ways in which we can increase our leverage with the lender? What circumstances would strengthen our bargaining position with the lender?

The more detail a borrower can provide regarding why past payments were late and/or missed, as well as how the borrower will remain current going forward, the more likely a lender will be to negotiate. Ultimately, however, the borrower must convince the lender that a loan modification offers the lender more value than any of the other alternatives available.

Thus, documentation is essential, not only to show why the borrower has been delinquent in the past, but to demonstrate how the modification will prevent reoccurrence of the problem. As noted above, the goal of a loan modification is to solve a borrower's problem and allow it to return to financial viability. It is not designed merely to delay an inevitable foreclosure or bankruptcy. A borrower will need to demonstrate how the modified payment plan will allow it to succeed going forward. Also, more detailed documentation demonstrates diligence and responsibility to lenders and provides a way for a borrower to demonstrate that the borrower is not being wasteful in other spending.

THE LOAN MODIFICATION PROCESS

What types of loan modification options are available? What modifications are borrowers and lenders typically agreeing to in this current market?

Typical ways in which a loan is modified include: (1) interest rate changes, such as a reduction in interest rate or a change from a floating to a fixed rate, (2) an extension of the loan term, (3) a waiver of late fees and/or other penalties that may be assessed, and (4) a reduction in principal owed and/or buyout of the loan at a discount. All of these have the potential to help borrowers by lowering the monthly payment that must be paid, and some reduce total payments as well.

Interest rate reduction: The monthly payments on a loan are allocated between interest and principal. An interest rate reduction benefits the borrower because it reduces the total dollar amount of interest to be paid, both over the course of the entire loan and in each period.

Example: The monthly payments on a 30-year, fixed mortgage for \$200,000 are \$1467.53 at an eight percent interest rate, but, if that rate is just one percentage point lower, at seven percent, the monthly payment drops to \$1330.60 – a difference of \$136.93 each month. A larger reduction in the monthly payment will result if the outstanding principal on the loan is higher or there is a larger reduction in rate.

Change from floating to fixed interest rate: With a fixed rate loan, the interest rate is constant throughout the term of the loan; thus, the same payment amount is due each month. The primary advantage to these loans is predictability; also, borrowers can lock in a low rate, if one is available. Conversely, an adjustable rate loan is just that – the interest rate adjusts based on the market interest rate at the time. When the market rate goes up, the interest rate on the loan also goes up, which leads to an increase in the monthly payment. The reverse is also true – when the market rate goes down, the loan interest rate follows, lowering the monthly payment. An adjustable rate loan may also have features such as a cap on the interest rate that may be charged or a lower, fixed interest rate for the first few years. Borrowers who initially had a low interest rate may be caught off guard if their payments increase dramatically after the introductory period. If a lower, fixed rate can be negotiated, the borrower will receive the benefits of both a lower payment and predictability of future expenses.

Extension of loan term: If the term over which remaining payments are made is extended, less will be due each month. A borrower should, however, keep in mind that the total payments made over the life of the loan will be greater – unlike in the case of an interest rate reduction.

Example: The monthly payment on a 15-year, \$200,000 mortgage at six percent interest is \$1,687.71, resulting in total payments of \$303,788 over the life of the loan. The

monthly payment on a 30-year, \$200,000 mortgage at six percent interest is \$1,199.10, \$488.61 lower, but the total payments over the life of the loan equal \$431,676 – an increase of \$127,888.

If the borrower is negotiating for the sale or refinancing of property that is security for the loan while facing an impending maturity default, and the sale or refinancing is a realistic possibility, a lender may provide a short-term loan extension until the close of the sale or refinancing. If a sale or refinancing is not likely, then the borrower must usually make certain concessions before obtaining an extension. Such concessions typically include a partial pay down of the loan and posting additional collateral and/or personal guarantees. As an added incentive to the lender, the borrower may consider offering a collateral pledge of cash proceeds from income-producing assets that are not related to the distressed loan.

Waiver of fees and/or penalties: In some cases, a borrower is unable to make required payments simply due to accumulated fees and/or penalties that are due. Convincing a lender to waive these fees will likely require the borrower to demonstrate to the lender why the late or missed payment occurred and its ability to make these payments in the future – the lender will need to be comfortable that this will not happen again.

Reduction of principal owed and/or buyout of the loan at a discount: A reduction in principal occurs when a lender agrees to reduce the amount of the loan, resulting in lower monthly payments and lower total payments, just like a reduction of interest rate. In a mortgage loan situation, for example, a lender may agree to simply forgive some part of the mortgage loan balance, which can be attractive to a borrower who is “upside down” or “under water” – meaning more is owed on the property than it is worth on today’s market. Alternatively, a lender may accept a buyout of the loan at a discount price if the property is under water, generating negative cash flow, and the borrower can demonstrate that a foreclosure sale is unlikely to yield a higher recovery. A buyout offers the lender a faster and determinate recovery on the loan while avoiding the costs and time typically involved in pursuing foreclosure.

A lender is least likely to agree to a principal reduction or buyout, however, because it requires the lender to permanently write down the value of the loan, hurting its balance sheet without any benefit if the property’s value recovers. Such a modification may be agreed to if an agreement with the borrower is reached that gives the lender some of the benefit of any later upswing in property value, which allows the lender to recover the reduced principal in the event property values recover. This can be done by providing the lender with an “equity kicker” – a shared appreciation arrangement – that allows the lender to share in the proceeds of any future sale. Alternatively, the parties can agree to a mechanism that automatically pays back the lender in the event the property generates any income and/or revenue.

How does the loan modification process work?

In order to determine if a borrower is eligible for loan modification, the borrower will be asked to **provide information and documentation** regarding its financial status. This may include, among other things:

- Documentation of monthly gross income, such as accounting books and records
- The most recent income tax return
- Documentation of assets, such as accounts receivables, inventory, real property and investments
- In case of a mortgage, documentation of any second mortgage or equity line of credit on the property
- Account balances and minimum monthly payments due on all other lines of credit, whether secured or unsecured, such as credit cards and term loans
- A hardship letter describing why the current loan is unaffordable

The lender may also exercise its right to **inspect the property** serving as collateral, as the lender may perform any reviews deemed necessary to determine whether the borrower has the ability to support continued payment.

Throughout the loan modification process, one of the most important things to remember is to **keep complete records**. The process can be complicated and lengthy, and a borrower can only help speed the process along by being as detailed as possible and maintaining signed copies of all documents submitted to the lender and all notices, forms and other communication received in return. It may also be beneficial to document all non-written communication.

What happens after a loan modification is approved? What are the legal consequences of successfully re-negotiating a loan?

If the borrower is approved for a loan modification and new terms are agreed upon, the lender must comply with all federal and state **disclosure and notice requirements**. In addition, the parties must **execute modifications or amendments to the loan documents, or entirely new loan documents**. Because the borrower and lender are modifying the original loan contract, the changes must be memorialized in writing.

We are trying to renegotiate a loan, but so far, the lender has rejected all of our proposed changes to the loan. Effectively, the lender has said the loan is a “take it or leave it” proposition. Why might the lender be taking such a hard position and refusing to negotiate the loan terms?

A lender will agree to modify a loan only if it believes that doing so is in its best interest. Foreclosure on real property, for instance, is a costly and lengthy legal process, and, afterwards, the lender still has to sell the property, resulting in additional time and expense. In addition, if the value of the property has dropped, as is often the case in the current market, the lender may foresee little return for its efforts. A loan modification can be significantly less costly for the lender, so a lender may deem modification a better alternative.

A lender does a cost-benefit analysis when deciding whether to agree to modify the terms of a particular loan. Part of this analysis is beyond the borrower's control – with a secured loan, for example, if the value of the property has not decreased significantly, or the lender believes it will sell quickly, the lender may not modify the loan, as it can recover more of the principal through a sale. Another consideration, however, is the financial condition of the borrower. If the borrower demonstrates that it will be able to remain current on a modified loan, it is more likely that it will be approved, but a lender will not modify a loan that it believes will eventually fall into default anyway. If the lender does not feel that the borrower will make the new payments for the life of the loan, the lender has little incentive to modify the loan. The lender would still be subject to the costs of collection down the road, and merely delaying those costs does not benefit a lender enough to offset the losses it would take by agreeing to a modification.

Do we have to stay with the same lender? What are the different concerns we should consider when we are contemplating taking out a new loan with a different lender?

Generally, modification involves staying with the same lender. Refinancing, as discussed in the introductory section above, can involve a new lender. Since refinancing essentially involves taking out a new loan in order to pay off the original loan, it is not only permitted, but advisable, to consider other lenders. The same considerations apply to refinancing loans as to original loans – costs of closing, title searches and appraisals, origination fees, insurance, escrow time and cost, etc. In addition, a borrower should carefully review the terms of the existing loan to determine if there are any prepayment penalties or if there is a period during which the loan cannot be prepaid ("no-call" period).

PERSONAL GUARANTEES AND OTHER PERSONAL LIABILITY CONSIDERATIONS

The lender required me to sign a personal guarantee for the organization's loan. What options do I have if the organization stops making payments on the loan?

A personal guarantee is when an individual agrees to be held responsible for assuming the debts of another person or entity in the event the borrower becomes delinquent. A lender may have asked for a personal guarantee when extending a loan to the organization, especially if the organization did not have sufficient collateral or credit history at the time the loan was made. This guarantee provides assurances to the lender that the individual fully backs the borrower and has motivation to make it succeed. So long as the borrower remains current on the loan, the personal guarantee does not come into play.

In the event that the borrower stops making the required loan payments, the lender can go after the assets of the person who supplied the personal guarantee, in addition to the assets of the borrower.

If the borrower becomes delinquent, the supplier of the personal guarantee should find out what he or she is liable for. The first thing to find out is whether the personal guarantee is limited or unlimited – if unlimited, it will cover 100% of the outstanding value of the loans plus related legal costs, while a limited guarantee contains a cap on liability, either as a percentage of the outstanding debt or a dollar amount. Also, the guarantor should look to the terms of the loan – is the lender required to go after the assets of the borrower first? If not, the lender can go after the personal assets of the guarantor, such as his or her home, before seeking to satisfy the debt by foreclosing on the borrower's property.

I'm a director/officer of the organization. Is there a chance that I will be personally liable for the loan if the organization chooses to close and walk away from the loan?

If you signed a personal guarantee for the organization's loan, as discussed above, you are personally liable if the organization chooses to close and walk away from the loan. Even if you did not sign a personal guarantee, however, certain actions taken (or not taken) by directors and officers may be grounds for a lender to ask a court to disregard the limited liability provided by the corporate form and hold the directors and officers personally liable for any loans taken out by the organization (this is known as "piercing the corporate veil").

For example, personal liability can result when: debt is knowingly incurred when the organization is already insolvent; the organization is undercapitalized in the context of the activities it conducts; required member or director meetings are not held, or other corporate formalities are not observed;

corporate records, especially minutes of directors meetings, are not properly or adequately maintained; and there is a general commingling of organization activity and/or funds with those of the person or persons who control the organization.

DEFINITIONS

A **mortgage** is actually the transfer of an interest in property to a lender as security for a debt. When the interest in the property is transferred to the lender, this creates a **lien** on the property.

A **mortgage note** is the legal document obligating a borrower to repay a loan at a stated interest rate during a specified period; the agreement is secured by a mortgage that is recorded in the public records along with the deed.

Throughout this handout, whenever a “mortgage” is referenced, this means a mortgage note.

The parties to a mortgage are the **mortgagor** and the **mortgagee**. The mortgagor is the party that is borrowing money. The mortgagee is the lender.

The **term** of the mortgage is the time period over which payments are made. In general, the mortgagor makes monthly payments to the mortgagee. Those payments are made up of **interest** and **principal**. The principal is the original amount that is borrowed and is usually equal to the value of the property that was mortgaged. The interest is a percentage of the principal. It is a fee charged by the lender for allowing the borrower to use the money.

A mortgage **amortizes** over the term of the loan. In general, amortization refers to the gradual elimination of a liability, such as a mortgage, in regular payments over a specified period of time. As a borrower makes principal and interest payments over time, less will be owed to the lender until the balance has been paid in full. Once the principal and all interest due on the debt has been paid to the mortgagee, the mortgagee transfers the interest in property back to the mortgagor, and the property is released from the lien.

Loan servicer: In many cases, the contact person for a particular loan is the loan servicer, which may or may not be the lender. The loan servicer collects monthly payments and is responsible for the accounting and management of the loan. Throughout this document, wherever the words “mortgagee” or “lender” are used, this refers to the loan servicer, if there is one. For example, under “How does the loan modification process work?” rather than contacting the lender directly, if there is a loan servicer, a borrower should contact the loan servicer.

Residential property: In most cases, this refers to someone’s home, but it includes any property zoned for residential dwellings, including single-family homes, townhouses, multifamily apartments,

condominiums and co-ops. Borrowers should be aware that these types of properties may instead be zoned as commercial property, however, if the purpose of the real estate is to generate a profit.

Commercial property: This includes all types of property zoned for business use, including office buildings, industrial property, medical centers, hotels, malls, retail stores, shopping centers and farm land. In addition, some property used as a dwelling may be classified as commercial property, if its purpose is to generate a profit. This is most common in the case of multifamily housing buildings.

Residential mortgage: This is a mortgage that is secured by residential property. Loans secured by residential property amortize over a set period, typically 30 years, which means the borrower makes periodic payments of interest and principal over the course of that period. At the end of the 30 years, the loan has been paid off, and the borrower owns the property outright.

Commercial mortgage: A mortgage for which the collateral is commercial property. Loans secured by commercial property are generally taken out by business entities, rather than individuals. In addition, the payment terms of commercial mortgages differ from residential mortgages in that the amortization schedule is generally calculated independent of the term.

Example: A 10/30 loan has a 10-year term and a 30-year amortization schedule – for the first 10 years, the borrower is required to make monthly payments of principal and interest that would result in payoff of the loan in 30 years. At the end of that 10-year payment, the borrower is expected to make a “balloon payment” equal to the remaining outstanding principal amount.

Recourse loan: A recourse loan is secured by a pledge of collateral, often by a mortgage of real property. In the event the borrower defaults on the loan, the lender can seize the property, and the borrower is personally liable for any deficiency. This means that, in the event that the collateral is worth less than the balance due on the loan – for example, as in the case when a mortgagor is “under water” – the lender can then obtain a deficiency judgment for the difference between the amount owed and what the collateral was worth. The lender can then seek to have that deficiency judgment enforced against the personal assets of the borrower.

Non-recourse loan: Like a recourse loan, a non-recourse loan is secured by a pledge of collateral, often by a mortgage of real property. Unlike a recourse loan, however, the borrower is not personally liable for any deficiency. While the lender can seize the collateral – real property in the case of a mortgage – the lender’s recovery is limited to that collateral. In the event the collateral is worth less than the balance of what is due on the loan, the lender cannot recover the difference – from the borrower or anyone else.

Deficiency judgment: This is a judgment that allows the lender to recover the difference between the value of the collateral and the amount still owed on the loan. Such a judgment can be enforced against any other assets of the nonprofit – computers, bank accounts, etc.

Example: Assume an organization owes \$500,000 on a loan secured by a mortgage on its office building and that the organization defaults on the mortgage, forcing the lender to foreclose on the building. The lender then sells the building at the highest price it can obtain, which, due to a drop in real estate values, is only \$425,000. There is a deficiency of \$75,000 – the difference between the \$500,000 that is still owed and the \$425,000 that the lender obtained through the foreclosure sale. If the loan is a recourse loan, the lender can obtain a deficiency judgment against the borrower. On the other hand, if the loan was a non-recourse loan, the lender simply loses that \$75,000 – the lender has no right to try and collect that amount from the borrower.