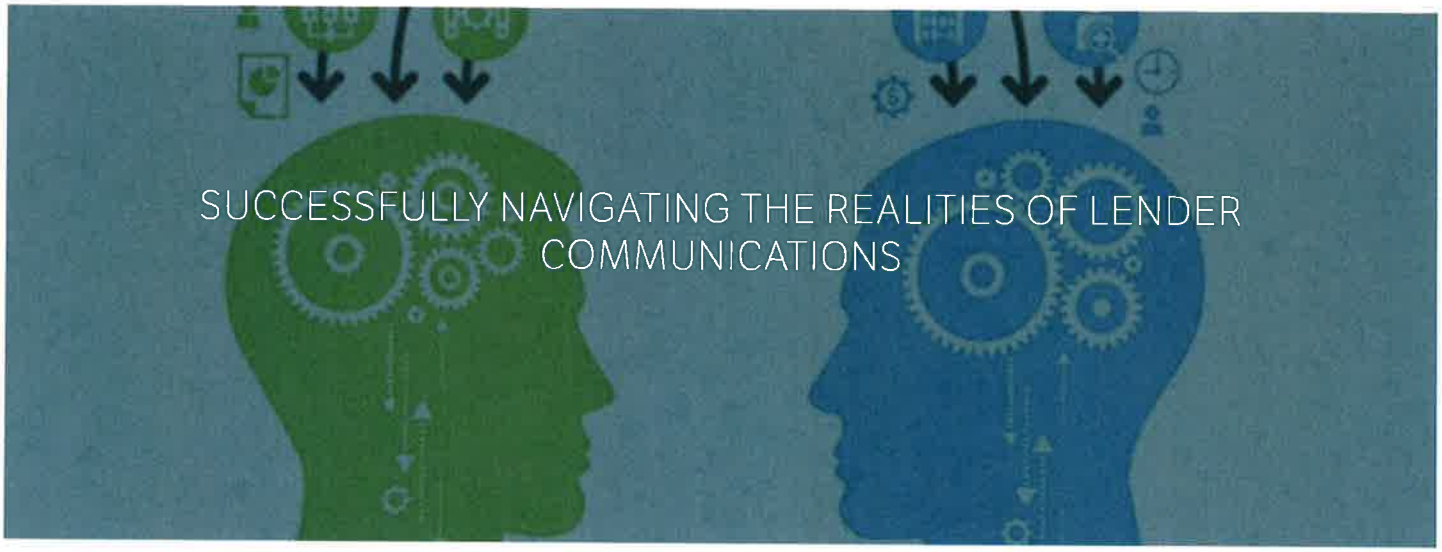

Why A Well-Managed Process Is Critical in Times of Trouble

By Bayard Hollingsworth

When operating in a default situation, the biggest risk confronting a borrower is that the lender concludes its "first loss is the best loss." Together with its close cousin, "Don't throw good money after bad," this old maxim often drives behavior in a workout. It is therefore critical for a lender to clearly communicate expectations to enable the borrower by presenting a clear roadmap during the workout process. It's also important for the borrower to reciprocate in the evolving relationship by demonstrating a willingness and ability to comply with the expectations of the lender regarding the information the lender needs to move forward. A borrower must confront the reality that the lender's actions will often be governed by a desire to avoid "throwing good money after bad," working towards a goal of avoiding a conclusion of "the first loss is the best loss." Open channels of communication enable a borrower to factually demonstrate why the lender is better off supporting the company through its challenges as opposed to throwing in the towel.

I have been involved with numerous default situations in which the borrower elected to minimize the flow of information and limit personal contact with its lender, largely because management was offended or confused by the lender's response to the default. This behavior was not a positive occurrence for the lender. Therefore, a lender must be mindful of unexpected adverse consequences of its actions. How a lender responds to a default can – often unnecessarily – make a challenging situation even worse. If a company is confronted with a lender's challenging response to an event of default, executing a strategy of reduced communication can create a downward spiral of decreased trust and increased aggressive behavior. This often yields increased reporting requirements, issuance of reservation of rights letters, and escalating threats concerning the exercise of the lender's "rights and remedies." These actions can presage foreclosure proceedings and bankruptcy filings. However, when a lender and borrower operate collaboratively to enable a predictable stream of good quality, timely and relevant information, the process can provide a foundation for maintaining a good working relationship during distressed times. A well-structured, predictable combination of written information, regular conference calls and face-to-face meetings can increase the likelihood that everyone remains "on the same page." In this way, trust and confidence can be maintained and even increased – a critical underpinning of a successful outcome.

What information is required by the loan and forbearance agreements?

This question should be carefully considered when the loan agreement is being negotiated and documented – i.e. – before it is signed – and it should be reviewed regularly by both the lender and the borrower, especially when an event of default has occurred, to ensure that all requirements for information are consistently met. When establishing reporting commitments, borrowers should be painfully honest with themselves – and the lender – as to the level of information that can be accurately and consistently reported. The borrower should avoid being aspirational in making these promises. The lender should look for signs that the borrower is struggling to develop and circulate requested information. These signs often include delays in delivery of information, duplicative information, or repeatedly broken promises to provide the information. These behaviors will likely continue once the loan is made, and the lender should make an honest determination concerning the acceptability of the information flow during the underwriting and credit approval process.

Overstating capabilities in this regard – or ignoring signs of trouble – can result in extreme unpleasantness and even disaster if the company later struggles to provide information contained in the loan agreement. If the borrower is unable to meet the reporting requirements of the lender, the lender's account officer and the borrower's CFO should take a step back and carefully consider whether the organization is ready to enter into a new loan relationship. This honest assessment is one of the greatest services a lender or a financial leader can deliver to his or her organization.

What sort of message is the lender sending?

When a default occurs, a lender should consider the style and tone of the communication it will initiate with the borrower. What tone does the situation require? This will obviously differ from the tone utilized before the loan defaulted. To what extent it differs is very important to consider. An aggressive or threatening tone can have the affect of causing the borrower to "batten down the hatches" and reduce the level of communication from the borrower instead of adopting a more collaborative initial stance. This, in turn, can possibly accelerate the realization of a loan loss. A lender can inadvertently change the direction of an otherwise successful workout process by behaving carelessly in the way communication is handled. There are few, if any, standards or correct answers as to the best way to approach the issue. A lender could be well advised to seek legal counsel, but also to temper the "lawyer's approach" in a way that optimizes the chances of achieving a successful business outcome based on sound judgment. Several principles are relevant at the commencement of a workout process.

1. ***The lender should establish clear goals for the loan relationship.*** Does the lender desire to continue the relationship with the borrower? Would the lender prefer to terminate the relationship and be paid out of the loan?

- ***The lender should communicate the urgency of the situation in a way that is consistent with its goals for the loan.*** Once the lender has determined the direction it would like to pursue, the source, style and tone of the communication should be carefully considered to ensure the goals for the loan and the communication strategy are aligned. For instance, a terse letter sent by the lender's legal counsel could result in an adverse reaction from the borrower and may be inconsistent with a goal of preserving a relationship – or at least providing for a productive environment in which to transition the relationship to a more appropriate capital provider.

- ***The lender should be very clear and detailed as to what information is expected of the borrower – and why it is needed.*** Is the amount of information required by the lender consistent with existing agreements, or is more information required to ensure the lender is better informed and more able to manage the loan in a responsive and patient fashion? A borrower should be expected to ask the lender why it requires any additional information being requested.

- ***Is the lender realistic in its requests for information?*** Is the borrower able to deliver the required information within the desired timeframe or will additional resources be necessary to help the borrower meet the lender's demands? If additional resources are required, what will be the lender's approach to the borrower in this regard, and how will that impact the style and tone of communication?

Of course, the amount, source, and tone of the communication is highly dependent on the circumstances of each individual loan situation.

What sort of message is the borrower sending?

The tone of communication works both ways, and the borrower should be aware that there may be a difference between the intended tone and the tone perceived by the lender. In troubled times, a borrower should pay special attention not only to the information provided to the lender, but also to how it is communicated. There are often new team members introduced to the process by the lender who have different perspectives and personalities than the regular portfolio management team. Their responses to any messaging may initially be difficult for the company to understand. It is important to understand that the tone of the messaging can be impacted by several behavioral aspects, including:

1. ***The borrower's receptivity and responsiveness to the lenders' questions and requests.*** Did the borrower handle the lender's request in a way that indicated the request was a priority?

2. ***The nature and amount of information provided.*** Is the amount of information provided to the lenders the bare minimum required by agreements in place, or is the borrower willing to provide more than the minimum to effectively respond to a lender's query?

3. ***The professionalism with which communications and meetings are handled.*** Is the borrower being respectful of the lenders' time by providing timely responses and being available, on time, and well-prepared for conference calls and meetings?

4. ***The general care and attention paid to the messaging.*** Are all communications thoughtfully constructed, accurate and free of grammatical, usage and, especially, calculation errors?

A lack of awareness of the impact of these behaviors can send a variety of messages to the lender ranging from respect, capability and cooperation to negligence, incompetence, or even provocation. Borrowers are often confused by the possibility of their behavior being perceived as provocative. What a borrower may not realize is that loan workout officers – especially ones newly assigned to an account – are not typically motivated or prone to interpret inbound communications from a positive perspective. They may, in fact, react in unanticipated negative ways to unclear messaging. It is very important to be aware of this possibility and communicate carefully and deliberately.

Establish a single channel of communication with your lender.

Information that is communicated to the lender should be fully vetted for accuracy and carefully controlled by the borrower and the lender. If there are multiple points of contact between the borrower and the lender, messaging can become fragmented and inconsistent. This often leads to confusion and misunderstandings. The borrower and lender should agree on a single point of contact on both sides of the relationship through which every aspect of communication – including scheduling of conference calls and meetings. Once the process is established, everyone participating in the process should be required to conform to it. Casual conversations and "back channel" communications should be avoided as these tend to complicate messaging and confuse the tone of communication unnecessarily.

Maintaining the cadence of communication is important.

Especially in a workout situation, a lender and its borrower should work to establish a regular and repeatable delivery schedule for information. This schedule should apply to all communications including financial statements, borrowing-base information, cash-flow forecasts, management reports, strategic updates, and any written discussion and analysis that may pass from side to the other. Even conference calls and face-to-face meetings should be governed by a regular schedule.

Once the schedule is established, the lender and the borrower should deploy any means necessary to achieve the agreed-upon timing. Deviations from the schedule should be kept to an absolute minimum. If an unforeseen event occurs that would inhibit meeting the schedule (such as turnover in staff), the parties should be proactive in informing each other to manage the schedule accordingly. In any event a pattern of communication should not be established unless both parties are certain they can meet the commitment.

How much "sausage making" can a lender tolerate?

After almost three decades serving as a lender, borrower, investor, and a leader of organizations of various sizes, industries, and states of health, I lean towards an attitude of openness when agreeing to provide information to lenders. However, sometimes painful experience has taught me that a given lender's ability to confront all the real "sausage making" that happens in managing an organization can have its limits.

A borrower must carefully evaluate what information is shared with its lender and what is not. If a lender's request for information could ultimately create confusion, a borrower should explain areas where this could be a risk. A lender's willingness to listen to this input is critical. A borrower's target is to keep the lender properly informed. but not over- or under-informed. This is a difficult and often nuanced balance to achieve. If a lenders' demands are outside of these boundaries – on either side of optimal – the borrower needs to open this conversation with the lender. The following questions can serve as a framework for determining what to communicate, and possibly what not to communicate to a lender.

- Is the information factually true or is it predictive? It is important to communicate facts to your lender, not engage in supposition or dis-regulated speculation.

- Can the information reasonably be considered material to the lender? Burdening the lender with immaterial information will likely only waste time and generate questions that will have little or no impact on the outcome of the situation.

- If the information relates to a potential future event or outcome, is it reasonably likely to occur or is it subject to a high degree of uncertainty? If the information relates to a highly uncertain future event, it's often better to wait until an increased level of certainly is associated with it before disclosing.

- Is the information required to be delivered by existing agreements? This is usually the most objective question the borrower will have to answer, and it is very important to be well informed about and to comply with these commitments.

- Have the company's attorneys reviewed the information and advised on the legal aspects of providing or not providing the information? Legal advice is very important in any disclosure of information to a capital provider. The borrower is well-advised to avoid extreme frugality and seek detailed legal advice.

It is management's role to manage the organization and a lender's role to provide capital and make decisions concerning the continuing availability of the capital. In agreeing to provide certain information, a borrower will need to weigh the various factors noted above and make a judgment call – in most cases incorporating the advice of their professional advisors.

Speak with your lender on a regular basis – don't just send emails.

There's no substitute for sitting down in person with your lender to discuss recent events at the company face to face. Merely emailing reports is not a strong basis for maintaining a successful relationship with your lender. Experience has shown that most people can be quite aggressive, fearless, and even offensive when communicating via email. However, when confronting an issue in person, behavior is generally of a far higher quality. While not always the case, a face to face meeting can enable a more rational and productive discussion when making difficult disclosures.

Avoid surprises. But if surprises happen, don't hide them.

Lenders hate surprises. However, a borrower should remember that lenders hate not hearing about surprises until well after the fact even more. Being the last to hear about bad news may also reduce a lenders optionality in responding to a situation. Lenders may perceive this behavior as purposeful, in which case trust will likely be degraded. In addition, the legal implications to the company's officers and directors should be carefully considered.

Trust – The most important factor

In almost every troubled situation, there comes a time when the correct path is unclear. Yet a decision must nevertheless be made, and action taken. In these situations, the lender may need to make a funding decision based on trust – having faith the borrower will act responsibly and keep them informed while doing the right thing. If a borrower has consistently provided good quality information, maintained an open dialogue, and kept a positive, productive tone, a decision based on trust is enabled. Without good quality communication, trust can easily be undermined, and a lender could well decide the time has arrived to pursue their remedies, believing it to be their best possible outcome.

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