

JANUARY 2016 NEWSLETTER

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THE NEGOTIATION OF A BUSINESS OR COMMERCIAL REAL ESTATE LOAN

FIRM ANNOUNCEMENTS:

A. 2015 TOP ATTORNEYS

Pozzuolo Rodden are pleased to announce that both Joseph R. Pozzuolo and Judith P. Rodden were selected as one of the region's top attorneys for 2015 by Philadelphia Life Magazine and Suburban Life Magazine. Mr. Pozzuolo was selected in two categories: business law/business planning and estate planning and administration. Mrs. Rodden was selected in employment law.

B. BLOGS

1. The following are a few of the business, tax and estate planning blogs posted on our main website www.pozzuolo.com during the past month:

- a. Estate Planning/Elder Law; Long-Term Care;
- b. Consideration A Must For Non-Compete Covenant;

- c. Employment Law- EEOC Roundup: EEOC's Year-End Suits Show Emphasis On Disability Bias, Retaliation And Sex Harassment;
- d. An Estate Planning Acronym- QTIP; and,
- e. Attorney Fees And Costs For Favorable Verdict For Retaliation for Taking Medical Leave

Please visit our website www.pozzuolo.com for more information on these and other relevant business, estates and employment topics.

2. The following are a few of the family law blogs posted on our family law website www.pozzuolofamilylaw.com during the past month:

- a. Reduction Of Child Support Denied: Decrease In Father's Income Not Of Sufficient Duration To Establish Permanency;
- b. Agreement To Arbitrate Post-Judgment Matrimonial Personal Property Disputes Enforced;
- c. Father's Inheritance Provided A Basis For The Court To Deviate From The Child Support Guidelines To Calculate Father's Earning Capacity; and,
- d. Child Custody Evaluation

Please visit our website www.pozzuolofamilylaw.com for more information on these and other relevant family law topics.

**Please visit our Facebook page to read all of our past and future blogs:
Pozzuolo Rodden, PC**

C. EDUCATIONAL SEMINARS ON YOU TUBE:

Pozzuolo Rodden, P.C. is pleased to announce you can view the following seminars taught by Joseph R. Pozzuolo and/or Jeffrey S. Pozzuolo at "Pozzuolo Rodden, P.C.- You Tube"

*The Negotiation and Documentation of Commercial Real Estate Loan Documents

*The Fundamentals of Starting a Business

*How Middle Income Families Should Plan for Retirement

QUESTION OF THE MONTH

What Is A Special Purpose Trust?

Answer-See Page 7 of this Newsletter

The Negotiation Of A Business Or

Commercial Real Estate Loan

With the relatively new Dodd-Frank borrowing restrictions passed by Congress, lenders being extremely rigid and uncompromising with borrowers, and the ever growing number of restrictive and rigid terms within loan documents in recent years, it is sometimes difficult to obtain a business or commercial real estate loan. You have lending officers soliciting and promising you terms and amounts very favorable for either your business purchase and/or business growth and falling short when you need the financing or you are stuck with months of costly delays negotiating 200 pages of one-sided legal documents with large legal fees and bank costs attached to them. This newsletter will discuss key aspects of the loan application process that will help you to position yourself to choose the right lender, know how the bank makes its decisions to commit to financing and the amount of loans and then review important negotiating points within the loan documents themselves.

Choosing the Right Lender:

If you are looking for a major electrical repair in your home you do not call a plumber, roofer, HVAC tech, or window contractor. Some of these other tradesmen may be handy, may have experience with electrical work, and may be able to help with simple or straightforward repairs, but they do not have the expertise that a seasoned electrician has if the job gets complex midway through the job. The electrician has seen it all and has repaired a similar internal problem a number of times.

The same applies for lending. Different lenders focus on residential home mortgages, home equity loans, auto-loans, business start-up loans, working capital loans, business expansion loans, asset based loans, commercial equipment leases, real estate construction loans, and commercial real estate lending. The lender that focuses on home mortgage lending may be able to complete your simple residential real estate loan, but likely will not have the expertise of a commercial real estate lender. Common commercial real estate ownership structures or valuing commercial rental real estate may be too complicated for them as John and Jane Homebuyer usually purchase a home individually and the financial evaluation is meeting certain wages/salary and loan to value thresholds -PERIOD! On the other hand, common real estate ownership structures will be second nature to the commercial real estate lender who is familiar with the more complicated valuation methods to give you proper credit for the rental cash flow. Thus, it is necessary to contact the right type of lender the same way you call the right tradesman. Also, do not be afraid to contact different lenders and obtain different quotes as with repairs.

For finding the right lender, ask around. If looking for real estate loans, ask commercial realtors or developers who they have been using. Ask the lending officer upfront whether his/her bank is promoting or discouraging your type of loan and if his/her bank is not interested ask him/her for referrals of other lending offices/banks focusing on your type of loan. Many banks are recently limiting their commercial real estate lending portfolio after the major losses during the latest financial crisis. Many loan officers have worked for other banks, and have friends in other banks, and are more than willing to refer you to a lender who focuses on the loan you need. Last, do not overlook smaller banks or credit unions versus the behemoth national banks. They can lend in larger amounts than you may think, you may be able to obtain more favorable terms, and the closing process will likely run much smoother. Further, do not overlook unconventional lenders such as private equity firms, private lenders, insurance companies, or internet based lenders.

How Banks Make Lending Decisions:

Lenders use a couple common metrics to determine whether to and how much to lend to a prospective borrower. Those being the loan to value ratio, the debt service ratio/debt to income ratio,

credit scores, available collateral/other assets, and possible guarantors/cosigners.

The recent Dodd-Frank “ability to pay” and “qualified mortgage” safe harbor rules have added even more restrictions on top of these metrics to further limit whom banks lend to and how much is lent. The Dodd-Frank ability to pay is that banks have to make a reasonable and good faith determination on a borrower’s ability to pay, otherwise, the borrower may have a legal claim against the bank for predatory practices. The qualified mortgage safe harbor places strict requirements that must be met to avoid legal liability to borrowers. It is important to know these metrics and banks’ regulatory restrictions in order to understand how they make their decision to present a better picture as a borrower.

Loan to Value Ratio: The loan to value ratio is simply dividing the loan amount by the appraised value of the underlying collateralized asset. This tests the ability to recover funds if you default. Most banks will not go above 70% and will place the loan in default for breaching the 70% threshold should the fair market value of the real estate decrease. If you are creeping close to or above this percentage amount, banks will not lend to you or they may limit the loan to an amount that keeps you under the 70% loan to value ratio.

Debt Service Ratio: This metric tests your ability to meet the payment obligations regardless of your assets and usually applies to business or commercial real estate loans. The debt service ratio is simply your annual cash flow prior to making debt payments divided by your required debt payments. In other words, if your annual cash flow after debt payments is \$300,000 and your debt payments were \$400,000, then your debt service ratio would be \$700,000 (your cash flow prior to debt payments) divided by \$400,000 or 1.75. Most banks will not lend if this ratio is below 1.2 and place an existing loan in default if the ratio is below 1.2. Banks may be lenient if the current ratio is close to the 1.2 threshold, but projected to increase over the foreseeable years. The higher the ratio, the easier it should be to obtain a loan and the more the bank will offer.

Debt to Income Ratio: This is similar to the debt service ratio but is more applicable to individuals. This simply looks at the debt payments during a calendar year and divides this number by the annual income. Under the qualified mortgage Dodd-Frank safe harbor, this ratio cannot be more than 43%. Banks will use this as a limit to either not lend to you or limit the amount lent.

Credit Scores: It is important to have a good credit score, but this is not the determinative factor. Many borrowers with great credit scores have been rejected or limited when applying for a loan. The credit score mainly tests your ability to pay on time and not necessarily your ability to handle the particular loan.

Deep Pockets: The last metric is related to loan to value, but loan to value is more local to the asset held as collateral. Deep pockets is the ability to pay globally or the bank’s potential to obtain future bank business. This means the borrower has substantial other assets, a business generating substantial future income, or having a personal guarantor/cosigner with deep pockets. The deeper the pockets the easier it is to borrow as they know you have the ability to pay the loan if the business goes south. Notwithstanding, for commercial lending unless you have extremely deep pockets relative to the existing debt with a personal guarantee, banks will likely still want you to meet the debt to service ratios and local loan to value ratios to avoid having the loan go into default in the first place.

Another aspect to the deep pockets is if the wealth is deposited within that bank, its wealth management division, or its brokerage division. If so, you may be able to borrow off a percentage of such collateral amounts or have more leverage since they do not want you to leave the bank. Therefore, another issue to consider when deciding on an independent brokerage firm versus a bank’s wealth management division is whether you may trade off slightly lower returns on investments to obtain a loan with more

favorable terms.

Understanding these metrics and where you fall within them will, many times, be the bank's reason for why you are rejected or offered less than requested. However, it is not as black and white as you may infer as where you fall may depend on the bank and its expertise, and certain banks may relax their terms and definition requirements to obtain your business. For instance, if you contact a lender with little expertise or inclination to obtain your business, it may give you a 1.1 debt service ratio because they valued your pre-debt cash flow at \$1.1 million because they are not familiar with your business or industry. If you go to a commercial lender or commercial real estate lender with more expertise it may assess your pre-debt cash flow at \$1.5 million by changing a few assumptions or definitions within its control. This is why it is so important to choose the right type of lender.

Loan Provisions and Documents:

After choosing the right lender, and ensuring your financials are attractive to a lender, you will be presented with numerous loan documents with multiple legal terms containing hundreds of pages. Below are some of the more important terms to note and be aware of especially to negotiate:

Interest Rate, Loan Fees/Points, Term: These are the meat and potatoes of a loan. Determine if the lender will give you a better interest rate, lower fees or fee caps, including bank and legal fees and costs, the percent lent on receivable and what receivables are eligible receivables, the percent lent on work in process and the definition of work in process, and the length of the loan to lower monthly payments or avoid fees and costs renewing the loan when the term expires. These terms are the heart of the loan whereas the others are more collateral issues on how the loan is managed.

Covenants: Covenants are ongoing promises and requirements that you make to the lender in addition to payments such as meeting certain financial ratios and financial metrics, and jumping through various hoops addressing inventory, work in process, monthly or quarterly financial reporting, in-house bank audits, control of business assets and maintaining a sole primary depository relationship. It is important to: 1) be certain you will meet these requirements now and in the foreseeable future; and, 2) request more relaxed requirements where necessary or you foresee a potential problem. Relaxed requirements will reduce additional costs and burden to maintain the loan and can include less stringent and less frequent financial metric testing, less financial reporting, and less general restrictions on what you can do with your assets.

Collateral: The loan will be secured by collateralized assets that are secured until full payment. There are generally restrictions on your ability to sell, lease, replace or use these assets in the course of business. At a minimum, insist that you are able to operate your business in its ordinary course and reduce the restrictions placed on your control of the current collateral, including after acquired financed machinery and equipment or leased machinery and equipment.

Guaranties: A guaranty is when a person or entity designated as a guarantor will have to pay for the loan if the original borrower cannot. They can be unlimited or limited to a certain amount or a certain term. If unlimited the lender can force the guarantor to satisfy the full amount owed on the loan meaning they could force you to sell your home if you and your spouse granted a personal guarantee. A limited guarantee may limit the lender's ability to recover from you to a certain amount such as 10 to 25% of the aggregate loan amount. If possible, request the guaranty to be removed completely or, if not possible, then to limit the guaranty to a financial amount, a fixed percentage or limited term such as the first two years of a five year term. This will depend on how successful the underlying business or asset. When a business first starts and has limited income, personal guaranties are usually required whereas as the business becomes more successful and can speak for itself, you should remove guaranties or at a

minimum have them limited without a spousal guaranty.

Prepayment: Many loans will not permit prepayment before the maturity date or only permit prepayment with a penalty. If possible, negotiate for the ability to prepay freely or with a lower penalty or decreasing penalty over the term of the loan. This ensures if the lender is tough or unreasonable in the future, you can simply leave and move your business elsewhere.

Depository Relationship: As stated above, a depository relationship can turn a rejection into an acceptance. Consider moving your deposits to the new lender or your brokerage assets to its wealth management division. Review the pros and cons of a possible lowered return versus obtaining the loan. On the other hand, many loan documents will require sole depository relationship. If you are happy with your current bank or the new lender is not a convenient depository, request this provision to be removed or that it simply be a primary depository relationship, not your sole depository.

Cross-Default or Cross-Collateralization Provisions: Under default provisions be careful for cross-default and cross-collateralization provisions. Cross-default is where a default on one loan is a default on all loans at the bank. Cross-collateralization is where an asset is collateral for multiple loans so the lender can foreclose on your assets if any of your loans default. Many lenders will put you to sleep with reasonable default provisions and terms within one loan, and then have harsh terms within another short term loan. This is especially so with future amendments or a short term additional loan that contains terms that was originally negotiated out. If cross-defaulted, the harsher terms would now apply to all loans making the prior negotiation a wasted effort. If cross-collateralized, then the bank could foreclose on all of your assets based on the harsher restrictions.

Right to Cure Upon Default: Many times a default is inadvertent where you failed to meet a particular metric for a short period of time due to a mistake or to a recent large purchase or transaction which caused you to be out of covenant. Request the ability to cure all defaults within 30 days. Every business has a rough period at times and it ensures you are treated humanely rather than unfairly foreclosed upon based on a technicality. Many lenders will provide it even if rejected at first.

Catch-all Default: Many documents state that a lenders may declare a default if it feels insecure at its sole discretion. Demand that such a clause be removed. With such a clause, lenders could force a default if, for instance, to simply obtain higher interest rates after a market interest rate hike or if it feels insecure lending in a certain market or area such as center city commercial real estate.

No Confession of Judgment Remedy: A confession of judgment is a powerful legal tool and remedy that allows a lender to enter a judgment of record against the borrower after an alleged default without notice and the opportunity for a trial or hearing. Although this remedy has been ruled unconstitutional as a denial to due process in some states and severely limited in other states, in Pennsylvania the lender must be granted this power or remedy within the loan documents. It has been our experience that many borrowers have been able to negotiate the confession of judgment remedy out of their loan documents. Thus, it is strongly recommended that borrowers protect their legal rights by striking this remedy from the loan documents and at a bare minimum severely limit the lender's right to exercise such a remedy.

Freedom for Distributions, Investment, Estate Planning: Many documents will try to require bank approval for each major business distribution, investment or estate planning decision. If there is such a restriction, request the freedom to make such decisions except when in default. At a minimum, permit tax distributions so the owners have liquidity to pay their personal taxes.

For what terms the lender will negotiate depends on multiple factors including how you make your presentation, how you stack on the metrics discussed in the sections above, how large the lender is,

and your general bargaining power (how much do they need you relative to how much you need to deal with them). Some lenders will not budge, but it is important to be aware of these provisions so you are not surprised when they try to implicate them after you have already received and used the funds. Last, obtain any changes **in writing** and avoid the “don’t worry about it, you know I’m reasonable” trap from the lending officer. While you know the current lending officer and know he would treat you fairly, he may pass away, transfer to a competitive bank, move to another position within the bank, move to another part of the country, . . . , so you do not know the mentality of or your relationship with the future potential lending officer and negotiate knowing that. Further, lenders may say one thing now and then forget about it five years from now when the issue arises.

In summary, the current lending environment is much more restrictive than it was a decade ago, however, if you do your homework by selecting the right lender, making your final presentation very professional including all financial ratios and financial metrics, and being aware of the various lending document provisions, you will be able to better navigate the current economic lending landscape.

QUESTION OF THE MONTH:

What Is A Special Purpose Trust?

Although a Special Needs Trust is one type of Special Purpose Trust, this Question of the Month is not written to address Special Needs Trusts. A Special Purpose Trust is one type of trust drafted to accurately execute a Settlor’s instructions to meet the particular needs of either the Settlor or the beneficiary. Example of Special Purpose Trusts include spendthrift trusts, trusts for those whose jobs carry a high financial risk, trusts for beneficiaries suffering from mental, health or physical disabilities or as simple as instructing the Trustee to sell the trust property to pay off the debts of the Settlor or the beneficiary.

One of the realities parents have to confront when creating an estate plan is the abilities of their adult children to handle and manage money. If an inheritance will be significant, receiving all that money at once can be completely overwhelming and lead to a child making financially irresponsible decisions. For this reason, parents often choose to stagger distributions of principal over 5, 10, or 15 year periods, even if their children are middle aged and financially independent. In the event that one of your children is particularly unable to manage money wisely, a spendthrift trust is one way to ensure your child is financially secure for years to come. With a spendthrift trust, your child’s creditors cannot levy on the funds held in trust and your child is not able to anticipate or pledge the funds while they are still being held in trust. Your trustee can have the discretion to make payments as he sees fit and can distribute funds either directly to your child or pay the funds for his benefit, such as paying his health insurance premiums, medical bills or mortgage directly instead of distributing the money to your child to be used for those purposes.

Similarly, if one of your children is likely to have legal troubles, you can draft a special purpose trust to keep his or her inheritance in trust for a longer period of time so that those funds cannot be levied on by a judgment credit. This kind of trust would be appropriate for a child who has a high financial risk jobs, such as being subject to potential malpractice suits. Additionally, if you are concerned about your child getting divorced and losing a large portion of his or her assets to a former spouse, this type of trust can ensure that the funds are not available for equitable distribution and cannot be converted into marital

assets.

Finally, one of the most important special purpose trusts is a trust that is drafted for the benefit of a child who has addiction or mental health issues. Your child might have periods of time when he or she is able to manage his/her finances and live independently and times when he/she cannot. By keeping the money in trust indefinitely instead of providing for certain scheduled distributions of principal, you can ensure that the money will be managed responsibly by your trustee and he will be able to make distributions directly for your child's benefit, to ensure that the rent is paid and to ensure that he or she is receiving the health care services he or she needs, such as mental health or addiction counseling.

In the most simplest terms, every family has unique needs and one of your children may have specific unique needs that must be addressed different than your other children. A "Special Purpose Trust" requires a trustee to actively execute the Settlor's specific, customized instructions to protect the child beneficiary with unique needs.

If you have questions about drafting a trust to meet the specific needs of your children, our experienced estate planning attorneys can help.

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- If there are any legal questions you would like this office to answer in the future, please email the question to us at info@pozzuolo.com. Each month, the question with the most relevance to our privately held business clients, advisors, and friends will be answered in our monthly newsletter. The questions can relate to any of the areas practiced by this office including business planning and transactions, corporate law, commercial litigation, employment law and litigation, commercial real estate and development, construction law and litigation, estate planning, estate administration, tax and pension law, family law litigation.
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PUBLICATIONS

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: [http://pozzuolo.com/Pubs Articles.shtml](http://pozzuolo.com/Pubs%20Articles.shtml)

CORPORATE/TAX ARTICLES

- Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business
- Deferred Compensation Rewards And Retains Key Employees
- Design Buy-Sell Agreements For Maximum Utility
- How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend
- How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations
- How To Look, Act And Sound Like A Professional Corporation
- How to Structure a Suitable Buy-Sell Agreement
- How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool
- Money Purchase Pension Plan Falls Out Of Favor
- Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

- Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules
- What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs
- Why An Employment Contract Is Mandatory

ESTATE PLANNING ARTICLES

- Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples
- College Funding Tool Offers Estate Planning Advantage
- Diversify Strategies For An Effective Estate Plan
- Divorce and Estate Planning
- Divorce Raises The Need For Performing An Estate Planning Review
- Drafting The Durable Power Of Attorney For Wealth Protection Purposes
- Estate Planning For Pet Owners
- Remarriage Situations Can Raise Special Estate Planning Considerations
- Six Proven Estate Planning Techniques
- Special Needs Trust - An Estate Planning Tool For The Disabled
- The Limited Liability Company -A Sophisticated Tool For Estate Planning
- Using Trusts To Maximize Family Protection And Minimize Estate Tax
- Why Living Wills- Advance Directives Are An Essential Part Of Estate Planning

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects. It is to provide insight into legal developments and issues. You should always consult with legal counsel before taking any action on matters covered in our updates.

This newsletter is courtesy of Pozzuolo Rodden, P.C.

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