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Expert Analysis

Real Estate Loan Workouts

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AS THE COVID-19 pandemic continues to place enormous stress on the commercial real estate industry—with hotels and shopping centers shuttered or experiencing depressed occupancy, urban apartments losing tenants and the lack of federal stimulus—an increasing number of commercial real estate loans is facing current or impending borrower defaults. The second quarter of 2020 reportedly saw a 65% increase in the overall delinquency rate for commercial real estate loans over the prior quarter, and upwards of $26 billion in commercial real estate loans have been downgraded to a rating of CCC or lower by a credit agency as of the beginning of September.

Lenders in default scenarios face a choice of whether to exercise remedies and take over their collateral, or (as has become the "practice prevailing in the current environment for balance sheet lenders," according to Moody's) offer relief measures to their borrowers, either in the form of short-term forbearance or a permanent loan modification.

A variety of factors incentivize lenders to pursue workouts over foreclosure, particularly if they have faith in the long-term economic prospects of their collateral. Most obviously, workouts avoid the need to engage in costly and protracted litigation. Even an uncontested judicial foreclosure in New York can last more than a year. In addition, many lenders—particularly banks and insurance companies—are unwilling to operate (or lack the in-house expertise to successfully operate) commercial real estate and are hesitant to assume the environmental and other liabilities that are incumbent upon an owner or "mortgagee in possession" of real property.

If a lender has confidence in the borrower and the borrower's default is market driven, the lender may believe that the borrower is in the best position to maximize the lender's recovery. Lenders may also be driven to work with their borrowers when there is a historic or ongoing relationship between the parties across multiple properties.

Finally, there may be accounting and regulatory incentives to grant borrower relief: certain lenders are required to publicly report "impaired loans," and if impaired loans are required to be written down or written off, capital adequacy rules may require the lender to increase its reserves; working out a loan to remedy defaults is often in the interest of both parties.

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On top of the usual incentives to pursue workouts, COVID-19 has made foreclosure proceedings even less of an attractive option, as stay-at-home orders and other public health measures have closed courtrooms and exacerbated backlogs. Not surprisingly, then, a survey in May by the American Hotel & Lodging Association found that 91% of its members with bank-owned loans solicited and received some kind of relief action this spring or summer.

Pre-Negotiation Agreements

The first step in the workout process is negotiating and entering into a pre-negotiation agreement. The most critical component of a pre-negotiation agreement is an acknowledgement by the lender and borrower that all communications in the workout negotiation

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process are deemed to constitute "compromise negotiations" for purposes of Rule 408 of the Federal Rules of Evidence and similar state laws, and therefore are not admissible in future litigation if workout negotiations fail. This clause encourages the parties to engage in open and frank communications—thereby increasing the likelihood of a successful workout—without increasing the risk of legal prejudice or exposure in a future proceeding.

Relatedly, another critical provision from the lender's perspective is an acknowledgement by the borrower that nothing said by the lender during settlement discussions constitutes a waiver of any default or any right or remedy that the lender has under the loan documents. The parties will also want to ensure appropriate bilateral confidentiality restrictions are included.

Lenders will frequently request that borrowers fully release them from any claims, offsets and defenses that have arisen as of the date of the pre-negotiation agreement, including lender liability claims. Borrowers may resist granting these releases in the pre-negotiation agreement (rather than in the definitive agreements) on the grounds that the pre-negotiation agreement functions more to preserve the status quo and to encourage further discussions. To the extent any such release is granted, particularly in construction loans where the underlying default consists of a failure to achieve construction milestones, borrowers should be careful to carve out from this general release any defenses that they may have under any force majeure or unavoidable delay provisions in the loan documents.

Finally, pre-negotiation agreements will invariably provide that no oral communications, correspondence or preliminary agreements will be binding on the parties until definitive agreements are executed by borrower and lender. Once a pre-negotiation agreement has been entered into, the parties can begin negotiating those definitive agreements, which will consist of either a forbearance agreement or a loan modification agreement.

Forbearance Agreements

In forbearance agreements (which are also known as standstill agreements), lenders offer short-term relief to borrowers by agreeing not to exercise remedies or take any other enforcement action for a specified period of time with respect to certain defaults. A critical provision in a typical forbearance agreement is an acknowledgement by the borrower that certain defaults or events of defaults have occurred and are continuing.

This is important from the lender's perspective because it limits the borrower's ability to contest the existence of those defaults if the lender elects to exercise remedies after the termination of the forbearance period. In addition, forbearance periods typically terminate automatically upon the occurrence of any default other than those which the borrower has acknowledged in the forbearance agreement (whether they arise before or after the execution of the forbearance agreement). As a result, it is important from the borrower's perspective for all existing and potential defaults to be acknowledged in the forbearance agreement, whether or not their existence is certain. Forbearance periods are occasionally subject to automatic extension if certain operational metrics are satisfied, such as an increase in leasing velocity or rent collection rates.

Forbearance agreements sometimes contain other forms of short-term borrower relief, including the waiver or deferral of interest payments (and/or the default interest component of interest payments) or required amortization payments during the forbearance period. To the extent that the lender is holding reserves or other cash collateral, borrowers may be expressly permitted during the forbearance period to apply those funds to operating deficits. In construction loans, lenders will sometimes agree to continue funding construction draws during the forbearance period if borrowers can either demonstrate that the loan remains in balance or deposit deficiency collateral.

Other common features of forbearance agreements include an update of the borrower's representations and warranties, a general release by the borrower of claims, defenses and offsets against the lender arising prior to the date of the forbearance agreement, and a ratification by the loan guarantors. Borrowers should carefully review any representations relating to the financial condition of the borrower or the collateral to determine whether it is appropriate for them to be modified in light of current conditions.

Many forbearance agreements also contain an express waiver of the automatic stay, which bankruptcy courts are more inclined to enforce if the waiver is given in the context of a workout. Forbearance agreements should also refer to the pre-negotiation agreement and acknowledge that it remains in full force and effect, as borrowers often use the forbearance period to engage in additional negotiations with their lender.

Loan Modification Agreements

Borrowers and lenders in a workout scenario may enter into permanent loan modifications either in lieu of, or after executing, a forbearance agreement. According to the FDIC, "Loan modifications should be pursued when the borrower's ability to make modified payments is reasonably assured, and the net present value of those payments exceed the expected recovery that would result from a foreclosure."

Loan modification agreements feature a variety of concessions from lenders and borrowers, most of which are designed to increase the likelihood that the lender will be repaid. In contrast to forbearance agreements, where pre-existing defaults are conditionally waived during the forbearance period, loan modification agreements tend to wipe the slate clean and include full unconditional waivers of pre-existing defaults.

Typical lender concessions include extensions of the maturity date, waivers or deferrals of interest payments for a specified period of time, and financial covenant relief, including temporary or permanent adjustments to debt service coverage ratio tests, debt yield tests and other operational covenants that the parties project will be unlikely to be satisfied for a specified period of time (due to the COVID-19 pandemic or otherwise). Less commonly, lenders will agree to permanent reductions in the interest rate.

In exchange for these concessions and the waiver of pre-existing defaults, borrowers are often required to provide the lender with additional credit support, including new or expanded guaranties, letters of credit or cash collateral. Borrowers commonly also agree to stricter cash management regimes, additional reporting obligations and the funding of new or increased reserves to cover interest payments, real estate taxes and other carry costs.

Interest rates may be increased, and amortization may be accelerated. Borrowers are almost always required to pay a modification fee, particularly if the modification includes an extension of the maturity date. Occasionally, lenders will require borrowers to inject new equity into their collateral by prepaying a portion of the outstanding principal balance of the loan to improve the loan-to-value ratio and reduce the likelihood of future defaults.

Borrowers and lenders also frequently use loan modification agreements as an opportunity to fix flaws or to update old-fashioned provisions in the original loan documents. For example, loan modification agreements entered into in the COVID-19 era frequently include the lender's latest LIBOR replacement language, which is often based upon the latest recommendations from the Federal Reserve Board's Alternative Reference Rates Committee (the ARRC). Similarly, the borrower may want to update the force majeure clause to account for pandemic-related issues. Lenders may also use the loan modification process as an opening to perfect any unperfected liens or otherwise fix issues with its collateral package.

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The representation, release and ratification provisions described above with respect to forbearance agreements apply with equal force in loan modification agreements. In addition, because loan modification agreements can alter the basic economic terms of the loan, lenders often require the recordation of an amendment to the security instrument to memorialize those changes. Updated title insurance, a new borrower's counsel opinion and other customary due diligence items are typically required in connection with recording the amendment to the security instrument.

If the collateral is subject to mezzanine financing, a senior lender entering into a loan modification agreement should carefully review any intercreditor agreement that is in effect to determine whether the mezzanine lender's consent is required for any of the contemplated senior loan modifications. Often, the mezzanine lender will need to be brought into the negotiations as a direct party, and at a minimum the parties need to coordinate with the mezzanine lender throughout the process.

Conclusion

The economic disruptions caused by the COVID-19 pandemic have catalyzed a burst of loan workouts over the last few months, consisting of both short-term forbearances and long-term loan modifications. However, the negative trajectory of the pandemic in the United States, the continuing lack of federal support and the uncertainty over the timeline for the development and deployment of a vaccine have led some to question how long lenders will be willing to abstain from taking enforcement actions, particularly in the beleaguered hospitality sector.

The institution of foreclosure proceedings last month by Wells Fargo with respect to Chicago's historic Palmer House Hilton—one of the first major foreclosure actions during the pandemic—has intensified speculation that at least some lenders have begun to move beyond the consensual workouts that were widely pursued during the first phases of the pandemic.