Sills Cummis & Gross P.C.

COVID-19 Legal Resources

Client Alert

Issues Facing Commercial Mortgage Lenders in the COVID-19 Pandemic

The far-reaching impacts of the COVID-19 pandemic will create challenges for commercial mortgage lenders and their borrowers. Rents, and therefore borrowers' ability to make debt service payments, will be curtailed as, for example, retail tenants are forced to shutter their businesses and apartment dwellers face economic hardship on a rising tide of unemployment. In this environment, lenders will face tough decisions on how to proceed with transactions that have yet to close and with closed transactions that are running into trouble.

Deals in the Pipeline

In the commercial real estate world, whether you are a borrower or a lender, one question you will be asked countless times during the pandemic is, "What do you have in the pipeline?"

From the commercial mortgage lender's perspective, the pipeline likely means the loan transactions for which a term sheet or a commitment letter has been issued to a borrower, and for which no closing date has been set or for which various closing conditions have not yet been satisfied. Most loans require as a closing condition that on the date of closing, no adverse change in the economic viability of the project or the borrower shall have occurred since the date the loan terms were agreed upon. Given the extreme economic uncertainty now pertaining in the United States, and virtually everywhere else, it is hard to imagine a lender with deals in the "pipeline" that is not asking, "Do I have to fund?"

Many times the answer to this will be found in the list of closing conditions set forth in the term sheet or commitment letter. The condition addressing material adverse changes can vary greatly from lender to lender and deal to deal. One version of this condition is the following: "The absence of any material disruption or material adverse change in current

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financial, banking, or capital market conditions that in the sole judgment of the lender, could materially impair the loan." The clause may also appear more simply and require only that there is "no material change in the market value of the project or condition of the borrower."

As long as this terrible pandemic is impacting the country, it would seem to be nearly impossible for a lender to be able to accurately underwrite an asset under existing conditions, even one for which it had planned to lend against as recently as two and a half weeks ago. Borrowers who have based major equity investments and personal guaranties on the value of a project will have the same concerns.

However, there are borrowers that retain confidence of the same level as they had a month ago, and who may insist on closing. It will behoove lenders with deals in the pipeline to immediately review the closing conditions in their documents to determine the answer to "Do I have to fund?" If the answer is "no," a lender could decide to either close regardless or terminate the transaction. However, a third option also exists, whereby a lender could invoke the material adverse change clause as the basis for introducing new lender protections to the deal. For example, a lender could require that the borrower fund a debt service reserve at closing, require additional guaranties, or require that the loan terms include cash management features such as a lockbox.

Modifications to Loans That Have Closed

With the economy in turmoil, borrowers will be contacting secured lenders to discuss their actual or anticipated inability to make debt service payments. Most lenders will require that borrowers in distress propose specific modification terms, as opposed to non-specific requests for relief. A borrower might request modifications such as a reduction in the interest rate, the conversion of an amortizing loan to require interest-only payments for a period, or some other waiver, reduction or deferral of payments. A borrower might also want to take the approach of adding investors to its capital stack, and therefore request that the lender consent to the addition of one or more new equity partners.

When faced with such requests, a lender will need to perform its underwriting on the proposed modifications to determine their feasibility and prudence. It would therefore be appropriate for a lender to ask for additional property and financial information and reports, perform a site visit, and require additional due diligence materials such as title, judgment and lien searches.

Such borrower requests for relief also present the lender with an opportunity to better protect itself. Upon receiving a loan modification request, a lender should review its loan file in order to identify and correct any deficiencies. The following are but a few of the inquiries that should be included in such a review of the loan file. Are any documents missing? Have all documents been properly recorded or filed? Do the documents contain any errors? Is all insurance up to date with the lender properly named?

In the end, a lender might agree to the borrower's requested loan modifications (or some variation thereof). The lender could also add its own conditions to the changes requested by the borrower. For example, a lender could require new reserves, a letter of credit or other additional collateral, a new guaranty and/or new cash management arrangements. If some sort of a deal seems possible, the lender should require a pre-negotiation agreement before discussing terms. If it turns out that a deal is not to be had, the lender might agree to enter into a forbearance agreement, in order to give its borrower time to turn things around or find takeout financing. Both of these types of agreements are discussed in more detail below.

Pre-Negotiation Agreements

Before having any substantive discussions, the lender should require any borrowers and guarantors (the "Borrower Parties") sign a "pre-negotiation" or "pre-workout" agreement ("PNA") in order to allow the parties to have frank and open discussions about a potential resolution to the borrower's distress. The PNA should, at a minimum, provide the current status of the loan, including the admission of any defaults, and have the Borrower Parties admit the genuineness of the loan documents. The PNA should also (1) provide that any negotiations, discussions, draft documents, or loan modification proposals are non-binding until a definitive agreement is executed, (2) include provisions preserving the lender's rights and remedies under the loan documents, (3) provide for the mutual termination of the PNA by either party for any reason, and (4) confirm the ground rules governing settlement discussions, including that all discussions and writings be confidential and inadmissible for evidentiary purposes. Finally, and most controversially, the lender could require a full general release from the Borrower Parties to protect the lender from future lawsuits.

Forbearance Agreements

Because a lender may want to give the Borrower Parties some breathing room, one option is for the lender and Borrower Parties to execute a forbearance agreement. The purpose of such agreement is for the lender to agree to wait to begin exercising remedies (namely, foreclosure or suing personal guarantors), while giving the borrower time for the economy to recover or to seek refinancing. In exchange for the lender agreeing not to proceed against the Borrower Parties, the Borrower Parties should reaffirm the validity of the loan documents, the amount due on the loan, and provide the lender with a general release through the date of the Forbearance Agreement. The lender also can require the borrower to make reduced payments during the forbearance period. Lastly, the parties could use the forbearance agreement to cure any defects in the loan documents discovered after closing.

Conclusion

The economic impact of the COVID-19 pandemic spells bad news for commercial mortgage borrowers. In this environment, lenders will need to re-examine transactions that are currently in their pipelines. In addition, lenders should expect an uptick in requests

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for relief from borrowers of closed loans. In these uncertain times, lenders will need to be careful and exercise diligence in deciding how to proceed with troubled properties.

If you are at the pre-closing stage, or have funded a loan which has defaulted, or may soon go into default, or if you have any other questions, please do not hesitate to contact Michael Leighton, Joshua Howley, or Clint Kakstys. We would be happy to discuss these issues with you and, in light of the pandemic, will waive any charges associated with the initial phone call.

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