Practice Update

The Path to a Smoother Commercial Mortgage Loan Workout

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As the marketplace debates how long the commercial real estate slowdown will continue in response to COVID-19, inflation and rising interest rates, spiraling rate cap costs, declining values, and rising cap rates, commercial mortgage borrowers and lenders should use this time to prepare for the possibility that their commercial mortgage loans may not meet the pre-negotiated extension conditions and may require a forbearance or modification to avoid an event of default at maturity. Although some loans may already be in default due to strict "going dark" restrictions or material adverse change clauses, in many cases mortgage borrowers are barely limping along, scratching their heads about what to do if they cannot refinance or profitably sell in the current market. In response to looming maturities, increased vacancies, and rent relief requests from tenants, commercial mortgage borrowers should be reviewing their loan documents, analyzing their projected liquidity, formulating a plan (with revised income and expense budgets) for what the rest of their year is expected to look like at each asset, and, based on their new forecast, proactively reaching out to their lenders. The weeks and months prior to maturity are critical to both borrowers and lenders for gathering the information necessary to make intelligent choices.

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Information Gathering and Establishing Goals

At a minimum, mortgage borrowers should check their loan documents to verify if any rent relief proposals need to be approved by their lenders or if any extension notices need to be sent to their lender(s). Beyond that, mortgage borrowers should be maximizing what they know about their properties' current and future prospects and evaluating their priorities, such as:

- Deferral of interest payments;
- A temporary (or permanent) relaxation of cash trap triggers or financial covenant defaults;
- Application of reserves being held by their lender in lieu of an equity infusion;
- New performance deadlines; or
- The ability to bring in a new guarantor or equity partner.

Lenders should similarly be gathering as much information as they can about each borrower and each asset's tenants and evaluating the loan documents with respect to what remedies are available to them (both contractually and practically). A borrower's non-economic incentives (such as avoiding negative publicity) are sometimes more important to the borrower than the loan itself. Items to consider may include:

- Does the mortgage lender simply want to reserve the right to declare a default and/or exercise remedies in the future?
- Does it want the borrower to acknowledge that there's been a default to potentially avoid a waiver claim by the borrower?
- Are there reserves to be applied?
- Will new reserves need to be posted?
- What rights does the lender have with respect to any rent relief offered to tenants?

- Should the property manager be replaced (if the lender has that right under the documents)?
- Does the lender want to accelerate the loan and commence a foreclosure?
- Given the state of the market, would the lender (or a potential foreclosure purchaser) be able to operate the property any better (more efficiently and profitably) than the borrower?
- Have equity interests been pledged? Will the borrower be likely to litigate? or
- Might there be unintended consequences of an enforcement action (such as, for public companies, a decline in share price that further weakens the lender's credit party)?

Pre-Negotiation Agreement

Once both parties have reviewed the loan documents in light of current circumstances and gathered the information necessary to prioritize their respective goals, it is appropriate for the parties to start discussions about whether the lender might forbear its exercise of remedies and/or how the loan documents might be modified. However, before the exchange of information begins in earnest, both parties should protect themselves by entering into a pre-negotiation agreement (PNA) to establish the ground rules for these discussions. The basic elements of a PNA should include both parties':

1. Acknowledgment that the loan documents are in full force and effect;
2. Acknowledgment that neither party is waiving any rights and/or remedies by virtue of the ongoing exchange of information;
3. Agreement to keep all information exchanged confidential;
4. Agreement that nothing admitted or disclosed will be binding upon either party until a definitive written agreement can be agreed upon (whether a forbearance agreement or a loan modification agreement); and

5. Understanding regarding who the parties' respective representatives will be (it is critical at this stage that authorized decision makers are involved in the workout process to avoid unnecessary misunderstandings or delays).

Lenders should consider using a new team (both internal and external) to handle workout discussions to minimize the possibility that its representatives are unduly influenced by a longstanding relationship with a particular borrower. Lenders also typically require a borrower to pay the lender's costs in connection with the PNA and any eventual forbearance agreement or loan modification agreement. Lenders should consider whether to leave the PNA open-ended or to include a termination date (e.g., have the PNA expire automatically if, within 60 or 90 days, the parties are unable to agree upon a definitive written forbearance or modification agreement). Both lenders and borrowers should also try to reach an agreement regarding how funds received by the lender during the PNA period will be treated—will they be governed by the existing loan documents or treated in some other way?

Many lenders' forms also include an acknowledgment of the debt amount, admissions of a default, and various releases and waivers. Trying to achieve these advantages via a PNA is likely overreach. Although many borrowers worry that they have inadequate leverage to push back, such acknowledgments, releases, and waivers are more appropriate for the actual forbearance agreement or loan modification agreement in which the lender agrees to waive or forbear in exchange for the borrower's releases and waivers. Borrowers should push back on these until the forbearance or modification agreement stage, at which point the lender is at least giving the borrower something in exchange for the acknowledgments, releases, and/or waivers.

Workout Agreements

Circling back to the goals the parties want to achieve from their PNA discussions, lenders should consider whether to negotiate for additional events of default and/or additional rights and remedies that were overlooked in the original loan documents, such as adding a new guarantor, imposing a cash trap, requiring new reserves, or enhancing financial reporting obligations in response to impaired property financials. Lenders should also remember to make any relief that they agree to provide contingent upon the borrower's continuing performance, such that the borrower is (retroactively if possible) no longer eligible for the relief if there are future defaults or non-performance by the borrower. If the relief is granted immediately, the lender will have a harder time clawing it back after a borrower's future default.

Also important from a lender's perspective is making sure that, where appropriate, any relief granted to the borrower is temporary and not perpetual. Lenders often use a workout to obtain a deed-in-lieu-of-foreclosure that will be held in escrow to ensure borrower's future compliance with the workout terms. Lenders must also remember in evaluating any proposed workout to consider whether they have provided for sufficient incentives to keep the borrower motivated to fulfill its workout obligations. If not, the lender is unlikely to get the benefit of its bargain.

Borrowers should assess potential negative tax implications (both transfer tax and tax recapture) before agreeing to proceed with a deed-in-lieu. After reviewing their situation, borrowers must decide what loan provisions they most want their lender to forbear or modify, including:

- Is the borrower comfortable operating while in default under its loan for a few months if the lender agrees not to commence foreclosure proceedings during that period?
- Is it more important for the borrower to have its lender forgive or defer a month or two of interest

payments, or is it enough to get the lender to suspend financial covenant compliance or cash trap triggers for several months?

- What operational relief will the borrower need from the loan documents provisions in order to "right the ship"?
- Does the borrower need less restrictive leasing parameters (such as, for example, the right to grant rent relief to tenants)?
- Will it need a new equity member or guarantor?

The workout agreement is where this relief should be documented. Borrowers can also use the workout process to get their lender to release a guarantor under a recourse, carry, or completion guaranty in exchange for loan document modifications that benefit the lender in other ways.

Both lenders and borrowers should keep in mind that, assuming both parties are acting in good faith, cooperation will be key to ensuring the workout of a maturing loan. If both parties are thoughtful about setting priorities and are open to compromise, without using the opportunity to overreach, most loans can be stabilized until the markets recover.

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