CARLTON FIELDS

Loan Restructuring and Forbearance Agreements in the Face of COVID-19 – The Lender's Perspective

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The last few weeks have been very rough on borrowers, particularly in the hospitality and retail industries. Although there are a lot of unknowns surrounding COVID-19 and its impact on our health and economy, we do know that the impact on the operations and economic performance of real estate assets will be profound. Many owners of real estate are already having difficulties meeting their debt service and funding their required reserves. As COVID-19 restrictions and layoffs take hold, the resulting impact on property valuations will likely result in otherwise performing loans failing debt service ratios, debt yield, LTV, and other loan covenants.

To weather this crisis, borrowers and lenders will need to work together. Here, we summarize what lenders should request from borrowers in order to restructure or extend a loan or to agree to forbear on enforcement actions.

The First Step: The Pre-Negotiation Agreement

Before commencing any forbearance or workout discussions with a borrower, the lender should require that the borrower execute a pre-negotiation agreement. Even if the loan is not yet in default, but the borrower has indicated that a default is likely or wants to discuss forbearance or possible loan restructuring terms, a pre-negotiation agreement is an important first step. A pre-negotiation

agreement simply acknowledges that both parties have agreed to engage in negotiations and that neither party is obligated or committed to any course of action until a final written agreement is reached and executed by all parties. Pre-negotiation agreements will typically require a borrower to acknowledge that the loan is in default (if applicable), the exact amounts owed, and that the loan agreements are still in full force and effect. A form of pre-negotiation agreement is attached as **Schedule 1**.

Review the Loan File

Simultaneously with the execution of a pre-negotiation agreement with the borrower, the lender should also review all the documents in its loan file to make sure that all its rights have been properly perfected and that, in the case of CMBS/CLO loans, all rights have been properly assigned or transferred to a trust entity. With hospitality assets, the lender must make sure that it has a comfort letter from the franchisor and also that the rights under the comfort letter have been assigned or transferred to the proper party. A formal review of all the loan documents should be undertaken to identify any deficiencies that need to be corrected.

Declaring a Default

If and when a borrower defaults under the obligations of the loan documents, the lender should send (or have its legal counsel send) a default letter. The lender must be clear in the default letter; that means expressly use the word "default" and cite to the applicable provision(s) from the loan documents. Failure to take this step could waive the default after some period of time. If applicable, a default letter will also start any applicable notice and/or cure period. After any cure periods have expired, or if no cure period exists, the lender should send an acceleration/Event of Default notice demanding payment in full of the debt. The acceleration/Event of Default notice can also revoke the license to collect rents (frequently establishing the start date under recourse liability carve-outs for subsequent misapplication). Reserves may also be applied at this time, and setoffs against other accounts that the borrower has with the lender may be undertaken. In addition to other advantages, putting the loan in full default status increases the lender's leverage for workout negotiations. A form of default letter is attached as **Schedule 2**.

The Next Step (Option 1): Restructuring or Modifying the Loan

From a business standpoint, each party should bring something to the table that is generally beneficial to the other party in a loan restructuring. The essential economics are usually modified. The **borrower's "wish list"** for a loan modification typically consists of one or more of the following:

1. Writedown of principal/discounted payoff

2. Reduced interest rate
3. Reduced or deferred amortization
4. Waived or deferred payments
5. Waived or reduced yield maintenance and other financial covenants
6. Modified (more realistic) leasing or condo sale guidelines
7. Access to reserves held by the lender
8. Flexibility for new equity partners or subordinate debt

The **lender's "wish list"** for a loan modification typically consists of one or more of the following:

1. Paydown of loan or other cash infusion
2. Additional collateral
3. Increase the interest rate or amortization; shorten the period to maturity
4. Add guarantors or recourse to a non-recourse loan
5. Establish escrows going forward (tax, insurance, capital and debt service reserves, tenant work)
6. Activate or establish a cash management "lockbox" that controls cash flow
7. Obtain/require supplemental property information or reports
8. Reduce/eliminate borrower rights such as partial releases/substitution of collateral
9. Increase/enhance lender rights such as approval over budget or leasing
10. Correct any legal weaknesses/deficiencies in the existing documents
11. Waive existing offsets, defenses, or lender liability claims
12. Change in property management/leasing agent

The Next Step (Option 2): Forbearance Agreements

Forbearance agreements are different from loan modifications. In forbearance, the lender either (i) sees little chance for a borrower to turn the property around; a restructure would simply delay the

inevitable and may cause further deterioration in property value or (ii) believes that the property's struggles are fairly short term or result from broad systemic disruptions (such as the current COVID-19 crisis); a "pause" in enforcement actions could give the borrower (and the wider economy) a chance to turn the property around. In a forbearance, the parties acknowledge that the loan is in default and the loan stays in default, but the lender also "forbears" from remedy enforcement, and perhaps makes other concessions for a relatively brief period of time so that the borrower can try to find a way out of the problem, without waiving the underlying defaults. Forbearance agreements come in short-term and longer-term (reinstatement) variants.

The "Short-Term" Forbearance Agreement

Short-term forbearance agreements are fairly simple. Following a default, borrowers may request a short period of time in which to allow the economy to recover or to arrange for a payoff of the loan. A borrower may request a short-term waiver or deferment of loan payments, or a waiver of: (i) default interest; (ii) exit fees; (iii) prepayment premium; or (iv) some combination of the above. In return for additional time, the borrower makes forbearance payments, and perhaps pays the lender other negotiated fees. In this situation, both the borrower and the lender believe that the property issues will be resolved in the near term and that more elaborate arrangements are not necessary. The documentation itself need not be elaborate. Facing a high volume of defaulting loans triggered by the COVID-19 crisis, lenders may only need something fairly simple to allow time for an economic recovery. A form of short-term forbearance agreement is attached as **Schedule 3**. In return for the additional time, the borrower makes forbearance payments, perhaps with reduced monthly payments under the loan, and agrees to basic acknowledgments, including the validity of the loan and its terms and all amounts owed, and also waivers confirming that there is no current dispute with the lender (these should include a release of the lender through the date of the execution of the agreement). This agreement has the added benefit of avoiding transaction costs typically associated with formally amending the loan documents and can also be used to cure any deficiencies in the loan documents (including perfection and assignment issues) that are discovered during the loan document review.

The "Longer-Term" or "Reinstatement" Forbearance Agreement

When cash flow problems are short- to intermediate-term problems, such as those that may be triggered by the current COVID-19 crisis, and the borrower is otherwise unable to continue paying the loan but has the potential, over time, to make up the missed payments, the parties may be able to reach a more comprehensive agreement to reinstate the loan. This is sometimes referred to as a "reinstatement/forbearance" agreement. This situation may occur most frequently in the securitized loan setting in which the servicer's discretion to modify the loan is limited. Often, the PSA will allow the servicer to afford the borrower time to catch up and also authorize the servicer to forgive late fees and default interest. The parties may be able to reach an agreement on a reinstatement of the

loan whereby regular loan payments are resumed at some point, expenses of the loan default are reimbursed, and the missed payments are paid back over an interim period through supplemental monthly payments. A non-recourse loan can be converted to a recourse loan in this scenario as well to provide additional collateral and protection to the lender. A form is attached as **Schedule 4**.

Tax Considerations

Depending on the extent of the loan restructuring or forbearance, the original debt and the debt as restructured, or for which a forbearance is granted, could be treated as "materially different" for federal income tax purposes. If so, the transaction could be treated as an exchange resulting in taxable gain or loss. Typically, these exchanges result in a loss to the lender. *See Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), and the Treasury regulations under section 1001 of the Internal Revenue Code of 1986, as amended.

Disclaimer for Material and Attached Forms

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List of Schedules

- **SCHEDULE 1** - Pre-Workout Agreement
- **SCHEDULE 2** - Default Letter
- **SCHEDULE 3** - Form "Short-Term" Forbearance Agreement
- **SCHEDULE 4** - Form Reinstatement Agreement

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