

Turbulent Times Ahead—Remember the Real Estate Workout?

A Lexis Practice Advisor® Article by Malcolm K. Montgomery, Lisa M. Brill, Michael Pettingill, and Horton D. McKinney, Shearman & Sterling



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The time is nigh. Twelve years after the great recession of 2008, the COVID-19 pandemic has triggered a significant, and possibly unprecedented, economic downturn. In the turmoil of the great recession, real estate investors could no longer meet their debt service obligations. Borrowers and lenders faced declining valuations and rising vacancies. Then came the bull market with its historically low interest rates and high valuations. But now, here we go again. This article discusses the considerations that should be weighed by lenders and borrowers when faced with difficult choices during a down-cycle.

Overview

A real estate workout can be divided into the following overlapping phases: (1) the due diligence phase, where the lender reviews the loan files for completeness, defects or gaps in information, (2) the notices phase, where the borrower is given formal notice of a default and the lender must decide whether to declare an acceleration and make a formal demand for payment, (3) the pre-negotiation phase, where the borrower and lender agree on a pre-negotiation agreement setting the ground rules for workout discussions, (4) the forbearance phase, where the lender refrains from enforcing its rights and remedies in exchange for certain legal or economic concessions from the borrower and, if all goes well, (5) the successful resolution, which may consist of a loan modification, sale or refinancing of the asset. Along the way there is the continuing specter of litigation or bankruptcy (topics for separate articles), and whether the lender will decide that foreclosure is its best option. For now, let's assume there is a deal to be struck—a solution economically palatable to both parties.

Due Diligence

Proper due diligence by the lender is an essential ingredient to a prudently conducted workout. This is a fact gathering exercise. The lender should reexamine all loan documents for completeness and for defects or gaps in information. Any material events that have affected the property or any of the other collateral after the date of the original closing should be reviewed. For example, construction work may have been performed, new leases may have been entered into or a new property management agreement may have been put in place. Similarly, the original loan documents may have contemplated that the borrower would take certain actions that would benefit the collateral after the original closing. These might include performing environmental remediation work or immediate repairs that had been identified in third-party reports, obtaining an interest rate hedge or a myriad of other items. Were these items completed? If cash management was not in place at closing due to strong financial performance of the property, the lender should consider whether the current situation merits a hard lock box with the lender in control of the cash. The lender should also take this opportunity to confirm that all original promissory notes can be located. Likewise, the borrower should fully understand the state of play in order to anticipate lender demands and prepare to rectify any property deficiencies, although the lender should not count on cooperation from the borrower.

The lender should determine what deficiencies or gaps there are in the loan file. The lender should also determine whether any defaults exist under the loan documents. These topics are related because a lender may decide to waive certain defaults or forbear from exercising certain remedies in exchange for access to better property information, corrections to the loan documents or both. Mutually beneficial trades can only be identified with the benefit of proper due diligence. And such opportunities are best capitalized on in the early days before the borrower/lender relationship has soured.

When conducting the workout of a real estate loan, many factors come to bear, including the borrower-lender business relationship, the nature and scope of potential liabilities tied to the property, the tax, regulatory and reputational consequences of available courses of action and each party's particular skill set. All of these considerations influence the course of the negotiations and the ultimate path forward.

Default Notices

In cases where a default exists under the loan documents, the lender often makes quicker progress after sending a notice of default. Such notices preserve the lender's legal rights in respect of any identified default. Default notices tend to focus one's attention. They convey that the lender means business and that delay tactics may have dire consequences.

Depending on the nature of the default at issue, the loan documents may require that the lender send a formal written notice to the borrower to convert the default to an "event of default," following any applicable notice and cure period. In most cases, only after a default has ripened into a full-blown event of default will the lender be entitled to accelerate the loan and demand payment in full of all outstanding amounts. The lender should take special care to strictly follow the technical requirements of the notice provision in the loan documents—even if notice is not technically required, notice should be sent to alert the borrower that the lender is exercising rights and remedies. This may include directing the notice to all parties listed in the notice provision, delivering the notice by a means specifically called for under the loan documents, and keeping return receipts, fax confirms or other evidence that the notice was given (anyone remember faxes?).

Once there is an event of default beyond all notice and cure periods, acceleration of the loan may be the next step, effectively causing maturity of the loan. Acceleration notices must also pass muster with the courts. In New York, the courts require that any acceleration notice be "clear, overt and unequivocal." *Sarva v. Chakravorty*, 34 A.D.3d 438 (2d Dept. 2006) (the record fails to establish a clear and unequivocal acceleration of the mortgage debt). In particular, the lender should take care to avoid making forward-looking statements about its intent to accelerate, but should instead clearly state that the loan is, from that day forward, accelerated. (Note that New York courts are divided on whether using the words "will be accelerated" is a sufficient statement of intent.)

Before sending an acceleration notice, the lender should carefully investigate the likely consequences. Acceleration of a loan of material size can trigger cross-defaults under financings of other lenders to the borrower and its affiliates. Indeed, an acceleration notice could be ill-advised if the resulting turmoil is likely to reduce the odds of a successful

restructuring. Once the lender accelerates the loan, maturity is deemed to have occurred and a loan will need to be reinstated, not amended. Understanding the so-called “debt map” of the borrower, which should include the cross-default, cross-acceleration and other key connections among the borrower’s various debt positions, should be a principal goal of the diligence plan described above.

Pre-Negotiation Agreements

Before any significant workout negotiations start, a prudent lender will require that the borrower sign and deliver a pre-negotiation agreement. This agreement is intended to preserve the status quo during the period in which the terms of a possible loan modification are discussed. The basic idea is to provide an open forum for productive discussions without the fear of litigation. The agreement itself should not be adversarial. It should not demand admissions from either party that defaults or breaches have occurred or that rights under loan documents are waived—although the lender will often seek some comfort from the borrower that no surprise claims by the borrower against the lender exist at the time the pre-negotiation agreement is entered into.

Pre-negotiation agreements typically include statements that:

- Neither party is obligated to modify the loan
- No modification is binding until a written agreement is signed by both parties
- Either party may terminate the negotiations at any time without incurring liability
- The pre-negotiation agreement and the resulting negotiations are not a waiver of either party’s rights
- The negotiations (including any unsigned draft documents) are not discoverable or admissible in court – and –
- Any full or partial debt service payment accepted by the lender after default is not a waiver or amendment of any loan document

Once a pre-negotiation agreement is in place, the parties are free to have open and wide-ranging discussions about possible solutions to the economic duress facing the borrower and the property. But nothing in the pre-negotiation agreement should prevent a lender from simultaneously pursuing the remedies that are available under the loan documents. Indeed, cautious lenders often prepare mortgage foreclosure and other court filings while negotiations unfold, so as to not lose valuable time if the negotiations fail and in preparation of a potential acceleration

of the loan. And, if negotiations do drag on, a cautious lender should at least consider a two-track strategy whereby it would move ahead with its remedies while negotiations continue apace.

Notwithstanding a pre-negotiation agreement being in place, the lender should still be mindful of its actions from the start of the workout. Pre-negotiation agreements are not always possible due to business and borrower relationship considerations. Whatever the situation, the lender should avoid making promises it may not keep or exerting undue influence over the borrower’s business. The lender should be reasonable when considering requests from the borrower, particularly when capricious behavior may negatively affect performance of the property. If workout negotiations then fail, lender liability claims could be raised. Protecting against such claims should be a priority for the lender.

Forbearance Agreements

Forbearance agreements (also called standstill agreements) are agreements in which the lender agrees to hold off from pursuing a foreclosure or otherwise enforcing its remedies in exchange for the payment (often on a monthly or other periodic basis) of a so-called “forbearance fee” or other economic or legal benefits or credit enhancements. Forbearance agreement terms vary depending on the anticipated period during which they are expected to last and the relative negotiating leverage of the parties. But as a rule of thumb, the longer the term of the forbearance, the larger the forbearance fees, credit enhancements and other benefits required by the lender. Indeed, agreements documenting lengthy forbearance periods are the equivalent of full-blown loan modifications.

A forbearance agreement can benefit both parties. The borrower is given time to seek a sale, refinancing, or capital investor for the asset, while the lender is given the opportunity to shore up its position via corrections to loan and security documents (identified during the diligence stage described above), the receipt of a forbearance fee and, in some cases, one or more other credit enhancements of the sort described below.

At a minimum, a forbearance agreement should address the following topics:

- The term of the forbearance period and payment of the forbearance fee,
- The borrower’s acknowledgment of the debt and ratification of the loan documents,

- The forbearance period termination events,
- Cash management matters,
- Any deferral or modification to the debt service payment schedule – and –
- Cooperation by the borrower in respect of any lender information or reporting requests

Where circumstances allow, additional credit enhancements or more robust lender remedies could include any of the following, among others:

- Additional recourse guarantees
- Supplemental collateral
- Waivers of defenses by the borrower in relation to key lender remedies
- Acknowledgements by the parties of key underlying facts – and –
- The deposit by the borrower of a deed or assignment of collateral into escrow with release of such escrow (and delivery of such collateral to the lender) contingent only upon the termination of the forbearance period (The enforceability of such an escrow arrangement in respect of real property remains an open question in some jurisdictions.)

The parties may also use the forbearance period to hammer out the terms of an acceptable loan modification. An existing lender facing the real prospect of incurring losses may have far more incentive to offer realistic financing terms than a lender specializing in special situations or distress.

Looking Ahead

The economic expansion lasted for so long, it is easy to forget the lessons from the last recession and how distressed real estate loans should be approached. Remember the past. Time is the borrower's friend and the lender's enemy. Be vigilant for signs of distress and take appropriate action. There is no reason to panic. The toughest real estate workouts can be handled by following the right playbook: (1) quickly assess the severity of any active or pending defaults and diligence the asset and the loan documents to ferret out any problems, (2) take care to provide proper default and acceleration notices, (3) put a pre-negotiation agreement in place to create breathing room for the parties to negotiate without incurring unexpected liabilities, (4) be open to a two-track approach, whereby cure periods run while workout discussions are simultaneously underway, (5) consider the possibility of a forbearance period to better align borrower and lender incentives, and lastly (6) keep in mind that a successful workout is most likely achieved when you stick to the playbook and steadily press ahead. Good luck!

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Lisa M. Brill is the Americas Regional Managing Partner, Head of the Hospitality, Leisure & Gaming Industry Group and a partner in Shearman & Sterling's Real Estate practice. She has significant experience in real estate acquisitions and dispositions, joint venture formations and financing transactions and has worked extensively representing both institutional investors and real estate operating companies in the investment, ownership and development of real estate. She also represents lenders in different types of financing transactions, including mezzanine loans, construction loans, mortgage loans and hotel financings.

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