Thursday, November 19, 2020
2:00 – 3:00 p.m. Eastern

ACRELive!
Behind the Eight Ball:
Workouts in the Age of COVID

Panelists:

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Moderator:

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Ascertaining Reason(s) for Default

- Credit and/or Performance of Borrower or Principal
- Incompetent or Challenged Management
- Project – problem with tenants/construction/ground lease
- Trouble in the Capital Stack – problems with other Loan Parties
- Financial/Property Market or Property Sector Disruption
- Regulatory Constraints - Lender or other Loan Parties
- General Economic Conditions Unrelated to the Property or Borrower
- Too Much Leverage
- Coronavirus + Governmental Shutdown + Everything Related = ?

Strategies for Borrowers in the Face of a Default

- Borrowers should be prepared to respond to the impacts on their loans and their property, and for a workout should have a coherent game plan going forward
- In the case of COVID-19 impact, Borrowers facing hardships caused by the COVID-19 pandemic can seek to work with their lenders and take certain actions to help mitigate the impact of the pandemic on their properties and their ability to fulfill their debt obligations.
- While the following strategies will apply in any distress situation, they are particularly relevant now.

Maintaining Communication With Your Lender

- Borrowers impacted by the pandemic should establish open lines of communication with their lenders and loan servicers.
- Even if borrowers are not facing hardship at the time of initial contact, circumstances could change. Borrowers who maintain regular communication, are transparent about the changing facts at their property and do not "hide the ball" are more likely to garner sympathy and obtain relief, all things being equal.
- Asset managers should review loan covenants to make sure they timely send notices (e.g., major tenant defaults; material communications received from tenants; notice of third-party manager default; and for construction loans, notice of the occurrence of a force majeure event that could impact performance milestones and/or cause cessation of construction, etc.).

Lender Response To Default – Due Diligence First

- Review Loan Documents and Servicing File
- Ascertain Loan Parties - Borrower, Guarantors, and other Loan Parties
- Confirm Notice Timing and Contacts in Documents
- Retain Independent Specialists
- Obtain Third Party Reports
- Review of Leases and Contracts
- Consider a request for updated information about all of the above, to the extent not in the loan file.

Communication With Your Lender II – Possible Notices

- Borrowers should consider whether to seek to temporarily suspend formal notice requirements and establish with their lenders that email notices alone can suffice during this time.
- For loans (especially for hotels and some retail) with continuous operation covenants and for construction loans, even where there is no requirement to do so, many borrowers are notifying lenders of force majeure to avail themselves of contractually negotiated extensions of performance milestones and trigger contractual rights of tolling.

The Vernacular of COVID-19 Notices

- Force Majeure: pandemic, acts of God, governmental interdiction, events outside control of Borrower
- Unavoidable Delay
- Frustration of Purpose
- Impossibility and Impracticability
- Conflict with Obligations to Comply with Law

Applied to:

- Performance obligations
- Payment obligations

Maintaining Communication With Your Lender III – Content of Notices

- Force majeure notices should state the nature of the force majeure (with reference to the defined term in the loan documents) and describe the impact on the applicable loan obligation.
- In some cases, loan documents require the borrower to describe any mitigation efforts the borrower is undertaking, so borrowers should include any relevant details.
- COVID-19-related force majeure will almost never excuse a borrower's obligation to pay debt service or other monetary obligations. However, borrowers can seek relief from their lenders to access reserves and reallocate cash flow to keep their properties operating until they are sufficiently stabilized.

Pre-Negotiation Agreements

- When a borrower notifies a lender about a potential impact on borrower's ability to repay a loan or comply with certain loan covenants, lenders often respond by sending a prenegotiation agreement, or PNA, to the borrower. Don't panic; this is a standard precursor to any substantive discussion of loan modification terms.
- PNAs should merely preserve the status quo, so that borrowers and lenders can undertake nonbinding discussions without waiving their respective rights and remedies.
- To the extent possible, borrowers should resist admitting defaults, waiving defenses and granting any releases in favor of their lenders in a PNA or other agreement with the lender.

Fork in the Road – Workout vs. Enforcement

- Both borrower and lender are engaged in a delicate exchange to determine whether they are preparing for a workout or for an enforcement action or surrender of collateral
- Lender is concerned with avoiding lender liability claims and actions which may voiding a foreclosure after completion
- Even if a foreclosure is instituted, it is possible to terminate foreclosure after commencement
- Statute of Limitations Risk
- Reinstatements/Pay-Off

Workout Documents

- Forbearance/Standstill Agreement
- Workout Agreement
- Modification of Existing Loan, Collateral and Organizational Documents
- Title Clearance Documents and Title Policy Endorsements
- Capital Markets Requirements
- Borrower Confirmations and Consent of Guarantors and Other Loan Parties

Follow the Cash

- If borrowers anticipate near-term operating shortfalls, they should discuss with lender applying cash flow or existing reserves (particularly regularly funded reserves for capital expenditure; FF&E upgrades, etc., that are less pressing needs for the project) in order to pay employees, keep the lights on, pay taxes and insurance, and avoid liens.
- For loans with hard cash management where debt service is prioritized ahead of other carry costs, borrowers should request a departure from the cash management waterfall to fund immediate operating needs.
- If the property cannot operate, then there will not be cash to pay debt service before long.

Contributing More Equity

- Lenders may request that borrowers fund additional equity into a project to fund debt service and operating shortfalls. Borrowers need to assess, as a business matter, whether they have sufficient equity value in or long-term commitment to a project to warrant further equity investment.
- If Borrowers are willing to contribute additional equity, consider an enhanced priority of recovery of such funds, and alternatives such as deferred funding and guarantees.
- Borrowers also need to undertake a risk analysis of their recourse exposure if they are unwilling to fund additional equity.

Assessing and Avoiding Recourse Exposure

- This is a critical analysis for counsel and should be one of the first things evaluated by both lender counsel and borrower counsel.
- Questions include: Is there a payment guaranty or carry guaranty? Is loss recourse for nonpayment of taxes and insurance subject to sufficiency of cash flow? Is there loss recourse for unpaid trade payables?
- Are there potential recourse triggers for any loan modification steps or other asset management steps contemplated, such as suspending or minimizing operations, asset closure, furlough of employees, rent relief for tenants, and other COVID-19 related actions.

Requests for Tenant Relief

- Borrowers will be under pressure from their tenants to offer rent relief, particularly for retail or restaurant tenants, who have been forced to shut down.

- Borrowers should check their loan documents to determine whether they need lender consent before agreeing to rent relief, and even if they are not granting rent relief, should be consulting with their lenders regarding the communications they receive from their tenants.

- Develop a strategy for dealing with tenants to avoid liability and to create records. Consider a pre-negotiation agreement for discussions with tenants.

Foreclosure

- Strict Foreclosure
- Judicial Foreclosure Sale
- Nonjudicial Power of Sale
- Sale by Receiver
- Supplementary Proceedings – surplus/deficiency/lease termination
- Election of Remedies/Security First/One Action Rule

Other Lender Enforcement Alternatives

- Suit on Note/Guaranty
- Obtaining Rents – Receiver in foreclosure/activate assignment of rents
- Environmental indemnity, insurance coverage, nonrecourse guaranty, receiver engagement in clean-up, or collateral abandonment
- Deed in Lieu of Foreclosure
- Bankruptcy
- Protective Advances

Defensive Arguments for Borrowers Affected by COVID-19

- Several jurisdictions and the OCC have issued orders or guidance to lenders regarding sound banking practices of providing 90-day forbearance of remedies for borrowers affected by the COVID-19 pandemic, including the New York State Department of Financial Services, which issued new regulations requiring New York state regulated financial institutions to provide a 90-day forbearance of payment due on a residential mortgage of a property located in New York available to any individual residing in New York who demonstrates financial hardship as a result of the COVID-19 pandemic.
- In many states, courts are just opening for judicial remedies but eviction and foreclosure moratoria remain in place.

Defensive Arguments for Borrowers Affected by COVID-19 – Cont'd

- Although the applicability of the DFS regulation is limited to residential mortgages, other borrowers can cite the regulations as possible guidance when discussing forbearance options with their lenders. Where applicable, borrowers should use the opportunity provided by new forbearance guidelines to approach their lenders with a request for forbearance of collection or exercise of remedies where appropriate.
- Borrowers that were not otherwise impaired prior to COVID-19 and only impaired due to COVID-19 are likely to be more successful.

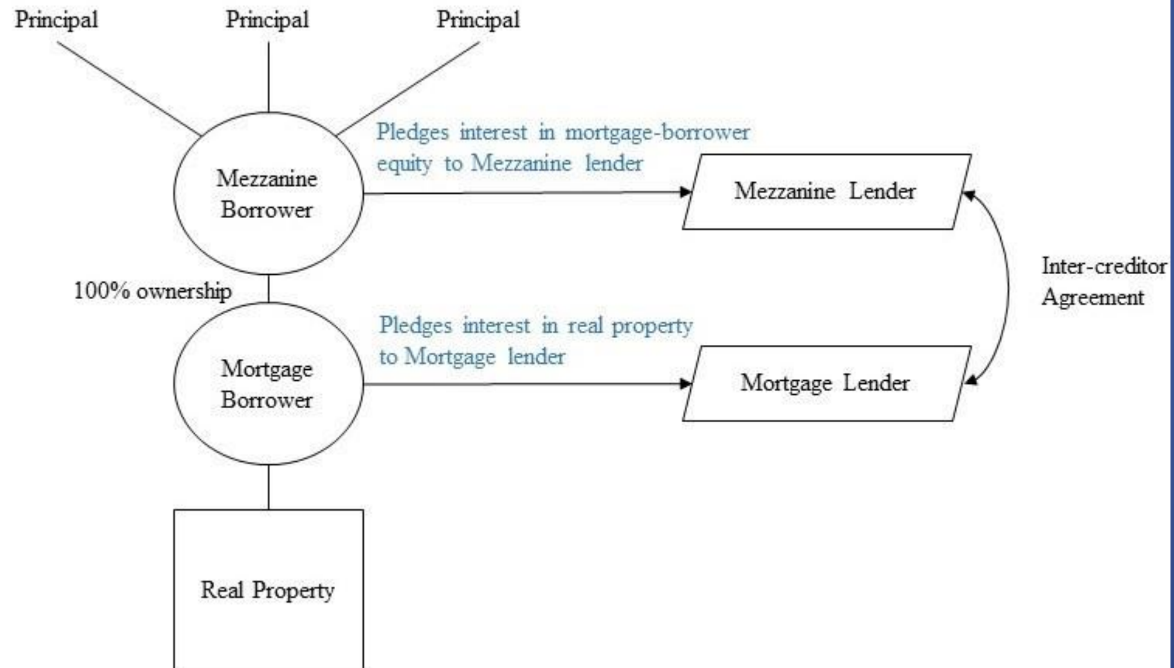
Other Assistance for Borrowers Affected by COVID-19

- Under new guidelines, Fannie Mae and Freddie Mac are each permitting their servicers to provide forbearance of remedies for up to three consecutive monthly payment dates to certain borrowers impacted by COVID-19, subject to the satisfaction of certain conditions (including borrowers agreeing not to evict tenants based on the nonpayment of rent as a result of COVID-19-related hardships).

Mezzanine Loans

- Capital stacks include both mortgage loans and mezzanine loans, which are one or more loans secured by direct or indirect equity interests in ownership interests in owner of the mortgaged property.
- Mezzanine loans are secured by a pledge and perfected under either Article 8 or Article 9 of the Uniform Commercial Code.
- Foreclosure of mezzanine loans is by non-judicial sale provided that the sale is conducted in a commercially reasonable manner.

Mezzanine Pledge



UCC Foreclosure Sale

- UCC foreclosure is non-judicial
- Can be completed in 14-16 weeks
- Integrity of process depends on commercially reasonable process of sale

Questions during COVID-19:

- Adequacy of Notice
- Adequacy of Disclosure
- Feasibility of real diligence
- In-person attendance with social distancing, ban on non-essential gathering

54 Madison Partners purported May 1 foreclosure of a 161-key project at 12 East 48th Street, slated to become a Hilton Grand Vacation Club, initially stopped by a TRO but ultimately, court allowed foreclosure to proceed.

UCC Foreclosure Sales

- Courts in New York have recently temporarily enjoined foreclosure in light of the pandemic:
- *D2 Mark LLC v. Orei VI Investments LLC*, Index No. 652259/2020 (inability to conduct due diligence because of shutdown), *Shelbourne BRF LLC v. SR 677 BWAY LLC*, Index No. 652971/2020 (N.Y. Cnty. Sup. Ct.) (32 day marketing period too short during COVID, and interpreting foreclosure moratorium to apply to UCC foreclosures; only delayed foreclosure sale for two months, did not permanently enjoin sale).

UCC Foreclosure Sales

- These cases represent a departure from a long line of New York cases holding that mezzanine borrowers could not demonstrate irreparable injury because they owned interests in LLCs, not real property. In the Mark Hotel Case, the Court's finding of irreparable injury was based on a provision in the loan agreement that limited the plaintiff's remedies to injunctive relief in the event that lender acted unreasonably. While most lender's counsel would have viewed the clause as limited to instances in which lender had unreasonably refused to grant consent, the Court interpreted this provision to establish irreparable injury because damages were unavailable. The Court did not find this line of authority persuasive because the parties' agreement precluded the borrower from obtaining monetary damages. Similarly, the decision in the Shelbourne Case appears to rely on the Mark Hotel Case's interpretation of the mezzanine loan agreement to find that monetary damages are unavailable to the mezzanine borrower in connection with a commercially unreasonable foreclosure sale. The further acceptance of the Court's interpretation of that provision will reduce what has long been one of the primary obstacles for a mezzanine borrower to obtain injunctive relief against a UCC foreclosure sale: the availability of monetary damages.

Intercreditor Agreements

- Intercreditor agreements are typical, but not required, between (if two) or among (if three or more) creditors in a capital stack.
- Among matters addressed by ICAs are:
  - Relative priority of the claims of creditors
  - Respective rights of creditors to exercise approval rights
  - Respective rights to notice and rights to cure defaults
  - Terms on which junior lenders can take ownership of their collateral following a borrower default, including any successor guarantee
  - Terms on which creditors are permitted to transfer their interests

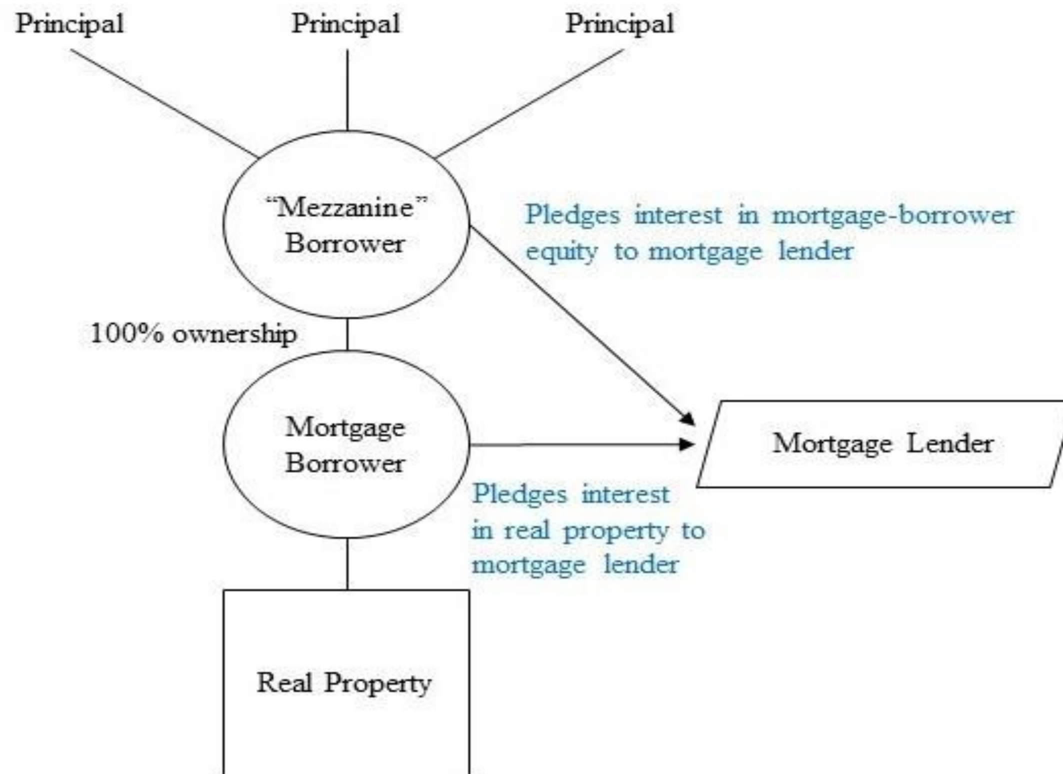
Borrower/Guarantor/Loan Parties Defenses and Claims

- Mortgagee in Possession
- Recharacterization As Equity
- Breach Of Good Faith/Fair Dealing
- Tortious Interference
- Oral Waiver/Modification
- Marshalling of Assets
- Release of Guarantor
- Clogging Equity of Redemption

Lender Liability Risks

- Taking Precipitous Action
- Threatening Action not Contemplated
- Interfering with Control or Operation of the Property
- Making Inconsistent Statements
- Calling an Improper Default
- Overreacting
- Creating False Hopes by: Inaction/Delayed Response

Accommodation Pledge



Reasons that Lenders Seek to Incorporate an Accommodation Pledge

- Access to UCC foreclosure: speedier, less expensive and non-judicial
- Avoid delay and expense associated with mortgage foreclosure, especially where foreclosures require judicial oversight
- Assertion that Borrower secured more favorable pricing in exchange for facilitating faster exercise of default remedies
- Similarity to mezzanine loans indicates absence of a legitimate objection to enforcement
- Absence of any reported case preventing enforcement of a mortgage because an associated accommodation pledge clogged the equity of redemption.

Reasons that Borrowers and Counsel Object to Giving an Accommodation Pledge

- Clogging the equity of redemption, thereby impairing the time-honored right to redeem and unenforceable on public policy grounds
- Undermining the protections afforded by judicially overseen foreclosure, particularly in light of the financial crisis experience of significant mortgagee lapses and abuses, further highlighting the public policy considerations
- Clogging the equity of redemption may jeopardize enforcement of the mortgage itself, when operating in equity
- Absence of clear law impairs ability to address enforceability in legal opinions
- Expansion of scope of non-recourse carve-out guarantees to shore up a dubious practice
- Added expense, diligence and documentation costs, as well as added title insurance costs, with no corresponding improvement in credit quality