CARLTON FIELDS

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

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This article is a companion piece to a similar article that examined loan restructurings, extensions, and forbearances from a lender's perspective.

While many different industries are being impacted by the COVID-19 crisis, no industry has been hit harder than the hospitality industry. While this article applies across all real estate types, it focuses on the hospitality industry and the metrics used by hotel owners in particular.

Recent weeks have been very rough on borrowers. Although there are many 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 real estate owners 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, debt yield, LTV, and other loan covenants.

To weather this crisis, borrowers and lenders need to work together. Here, we summarize the issues from the perspective of the borrower and make specific suggestions on what information a borrower should be prepared to provide to a lender in connection with a forbearance request.

The First Step: Understand What Lenders Need (and are prepared to do for good borrowers). Currently, lenders and CMBS servicers are working late into the night cataloging forbearance requests, primarily from hotels, then retail entities, then multifamily entities. Ninety-day deferrals on principal and interest payments for hotel loans seems to be the evolving default position for most lenders. However, in order to get a P&I deferral, many lenders are requiring: (i) the property's current cash positions; (ii) burn rates; and (iii) a specific interim request justified by the cash position and burn rate.

The Second Step: The Pre-Negotiation Agreement . Before commencing any forbearance or workout discussions with a borrower, the lender will usually require that the borrower execute a pre-negotiation agreement (even if the loan is not yet in default). 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**.

The Third Step (Option A): Restructuring or Modifying the Loan . Unlike forbearance (discussed in more detail below), a lender will consider a loan modification or restructuring only when it believes the borrower needs a longer-term solution for its debt service problems, but there must be a realistic chance that the loan can remain healthy in a modified format. From a business standpoint, each party should bring to the table something beneficial to the other party in a loan restructuring. In most cases, the essential economics of the loan are modified. The **borrower's "wish list"** for a loan modification typically consists of one or more of the following:

1. Reduced interest rate
2. Reduced or deferred amortization
3. Waived or deferred payments
4. financial covenants
5. Waived or reduced yield maintenance (if applicable)
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
9. Writedown of principal/discounted payoff

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 Third Step (Option B): 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 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 premiums; or (iv) some combination of the above. In return for additional time, the borrower makes forbearance payments and might pay 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 potentially defaulting loans triggered by the COVID-19 crisis, lenders may only need something fairly simple and standardized to allow time for an economic recovery. A form of short-term forbearance agreement is attached as **Schedule 2**. In exchange 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 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 3**.

Tax Considerations: It is also important to consider the tax ramifications of a loan restructuring or forbearance, although an extended discussion of tax treatment is beyond the scope of this article. 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.

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List of Schedules

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

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